STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company	)	
	)	
Application for Review of Alternative Regulation Plan	)	**Docket No. 98-0252**
	)	
Petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates	)	**Docket No. 98-0335**
	)	
Citizens Utility Board and People of the State of Illinois, ex rel. James E. Ryan, Attorney General of the State of Illinois, Complainants	)	
vs.	)	**Docket No. 00-0764**
Illinois Bell Telephone Company d/b/a Ameritech Illinois, Respondent	)	**(consolidated)**

GCI EXCEPTIONS

THE CITY OF CHICAGO
Mara S. Georges
Corporation Counsel
Jack A. Pace
Karen Coppa
Assistant Corporation Counsel
Regulatory and Aviation Litigation Div.
30 N. LaSalle St., Suite 900
Chicago, Illinois 60602
(312) 744-6997

THE PEOPLE OF THE STATE OF ILLINOIS
James E. Ryan, Attorney General
Janice A. Dale
Susan L. Satter
Assistant Attorneys General
Public Utilities Bureau
100 Randolph St., 11h Floor
Chicago, Illinois 60601
(312) 814-1104

CITIZENS UTILITY BOARD
Karen L. Lusson
One of its attorneys
349 S. Kensington Avenue
LaGrange, Illinois 60525
(708) 579-9656

COOK COUNTY STATE'S ATTORNEY'S OFFICE, Richard A. Devine, State's Attorney
Marie Spicuzza, Allan Goldenberg
Assistant State's Attorneys
Cook County State's Attorney's Office
69 West Washington, St., Suite 700
Chicago, Illinois 60602
(312) 603-8624

GCI/CITY'S EXCEPTIONS AND PROPOSED ORDER

By the Commission:

I. INTRODUCTION

In its Order entered on October 11, 1994, the Illinois Commerce Commission ("Commission") scheduled a five-year review to determine whether the Alternative Regulation Plan ("Plan") authorized for Ameritech Illinois was meeting the Commission's goals and statutory requirements. (Order, Docket 92-0448/93-0239 (consol.) ("Alt Reg Order")). Docket 92-0252 is that review proceeding. It was consolidated with Docket 98-0335 whereby AI requested rate balancing and with Docket 00-0764 wherein CUB and the AG seek rate relief.

Pursuant to notice given in accordance with the law and the rules and regulations of the Commission, this matter came on for hearings before duly authorized Hearing Examiners of the Commission at its offices in Chicago, Illinois.

The following parties intervened or entered appearances, by their respective counsel, in the instant proceedings: Ameritech Illinois, ("the Company" or "AI"), Staff of the Commission ("Staff"), United States Department of Defense ("DOD"), McLeodUSA Telecommunications Services, Inc. ("McLeod"), AT&T Communications of Illinois, Inc. ("AT&T"), Cable Television & Communications Association of Illinois ("Cable"), City of Chicago ("City"), Citizens Utility Board ("CUB"), Cook County State's Attorney's Office ("CCSAO" or "Cook County"), People of the State of Illinois ("AG") (CUB, CCSAO and the AG are collectively referred to as "GCI").

Evidentiary hearings was held in these consolidated proceedings from February 13, 2001 through February 23, 2001.

AI presented the testimony of the following witnesses: David H. Gebhardt; Thomas O'Brien; Mark E. Meitzen; William E. Avera; Rick Jacobs; Michael J. Barry; Timothy Dominak; William C. Palmer, Robert G. Ibbotson; David Sorenson; John Hudzik and Robert G. Harris.

Testimony on behalf of Staff was provided by: Robert Koch; Mary Everson; Diana Hathhorn; Bill Voss; Jeffrey Hoagg; James Zolnierik; Genio Staranczak; Judith R. Marshall; Sam McClerren; Mark A. Hanson; Alcinda Jackson; Joy Nicdao-Cuyugan; Alan S. Pregozen and Bud Green.

DOD presented the testimony of Harry Gildea. McLeod presented the testimony of Rod Cox. Cate Conway Hegstrom testified on behalf of AT&T.

The following witnesses testified on behalf of GCI/City: Ralph C. Smith; William Dunkel; Roxie McCullar; Thomas M. Regan; Lee L. Selwyn and Charlotte F. Terkeurst. Dr. Selwyn also testified for the City on certain issues.

Each of the witnesses identified above was available for cross-examination at the hearings. The record was marked "Heard and Taken" on March 2, 2001.

Initial Briefs were filed by DOD; CCSAO; AG; CUB; City; AI; AT&T; McLeod and Staff. Reply Briefs were filed by Staff; DOD; GCI/City; AT&T; AI; Cable and McLeod. The City, AG, County, and CUB filed separate initial briefs but filed a joint reply brief.

Partial Draft Orders were presented by AI, GCI/City, AT&T and McLeodUSA.

The Hearing Examiners Proposed Order in these consolidated dockets was issued on May 22, 2001. Exceptions and Briefs on Exceptions were filed by A.I, GCI/City, Staff, AT&T, McLeod USA.

Background

In 1994, the Commission entered an Order whereby AI would be regulated not under traditional rate of return regulation but by an Alternative Regulation Plan ("Plan") which caps its non-competitive rates and not its earnings. ("Alt Reg Order"). In approving the Plan, the Commission had to make seven affirmative findings under Section 13-506.1 and further consider the policy goals set out in Section 13.506.1(a) and the provisions of Section 13-103. Since Alt Reg. was new and untested, the Commission ordered a comprehensive review at the end of a five-year period to determine whether, and to what degree, it met statutory and regulatory goals and requirements.

The instant proceeding arose with Ameritech's March 31, 1998 filing of an application for review in compliance with the Commission's direction in the Alt Reg Order. (See, Alt Reg Order at 94-95). It is the first review of an alternative regulatory plan for a telephone company and the first review of Ameritech's Plan. In its Application, AI was required to address ten issues which established the scope of the instant review. It submitted the requested information in its direct testimony.

The analysis in this section of the Order is a historical one which seeks to assess how the Plan has functioned up to now. To be sure, certain items only required a simple listing of changes occurring during the plan (e.g., items e, f, g, h), while others are more substantive and forward-looking, such as whether the adjustment factor in the price cap index should be modified and whether the plan has met each of the established statutory and regulatory goals (c, j). (See Alt Reg Order at 95, 179-192)). Some of the issues were the subject of dispute and further analysis while others were primarily informational in nature.

The issue at this stage is whether the Plan, as established in 1994, has performed in accordance with both the statutory requirements and goals mandated in the Act and the regulatory goals and expectations set out in the Alt Reg Order.

II. THE 10 POINT REVIEW - Commission Specific Issues

Here we examine the ten specific items which AI was required to address in its application for review of the Plan.

(a) Does the inflation index and the manner in which it is applied provide an adequate reflection of economy-wide inflation?

AI's Position

AI maintains that the Gross Domestic Producer Price Index ("GDPPI") provided an adequate reflection of economy-wide inflation during the term of the Plan. According to AI, it is a widely accepted measure of economy-wide inflation for all goods and services produced by the U.S. economy and is used by the FCC and a number of state commissions in their price cap plans. At the time of the Plan's adoption in 1994, the fixed-weight version of GDPPI was the accepted and published inflation measure. In addition, a fixed-weight methodology was used to calculate economy-wide TFP and input price growth for purposes of establishing the X factor.

Subsequent to 1994, however, the Bureau of Economic Analysis of the U.S. Department of Commerce replaced the fixed-weight GDPPI with the chain-weighted GDPPI as the official measure of inflation. In addition, the Bureau of Labor Statistics has adopted chain-weighted measures in constructing economy-wide TFP, which also means that economy-wide input price growth is calculated on a chain-weighted basis.

Accordingly, AI maintains, the chain-weighted version of GDPPI should be used in the price index formula on a going-forward basis, along with chain-weighted versions of all other components of the X factor.

Staff's Position

In the Alt Reg Order, the Commission observed that a price regulation plan, such as the one at issue here, generally has at least two principal components: a measure of economy-wide inflation, and an offset to the inflation measure which measures productivity. (Alt Reg Order at 20). For that purpose, the Commission adopted the GDPPI as the measure of economy-wide inflation to be used in setting the price cap under the Plan. (Id. at 36.)

It further directed Ameritech to use a specific form of the GDPPI, called the "fixed weight" GDPPI, in its annual filings to date. The measure is produced by the Bureau of Economic Analysis ("BEA") and is revised periodically, with an annual revision occurring in August of each year. Staff tells us that this measure came into question in past annual filings due to the inconsistencies resulting from these periodic restatements in GDPPI data in a given year.

Staff provides the following example of how restating the GDPPI data can impact the amount of rate reductions in a given year. In Ameritech's Fourth Annual Filing, it reported the 1997 4th quarter GDPPI to be 114.4. In the Fifth Annual Filing, however, Ameritech reported the 1997 4th quarter GDPPI to be 113.4. According to Staff, the restatement of the GDPPI allowed AI to double-count 0.9% in inflationary change between the two filings. As a result, Staff claims, Illinois ratepayers were denied $9,248,761 in rate reductions in 1999.

Staff recommends that we discard the fixed weighted GDPPI in favor of another measure, i.e., the chain weight GDPPI. According to Staff, this chain weighted GDPPI is not restated in the same manner as the fixed weight GDPPI and, if adopted, would alleviate the problems it has described.

GCI/CITY

GCI/CITY support replacing the fixed-weighted GDPPI with the chain-weighted GDPPI.

Commission Analysis and Conclusion

The evidence shows that there have been problems with the fixed weighted GDPPI because it was restated periodically, resulting in double counting and a distortion of the inflation factor. Therefore, it has not been an adequate measure of inflation, and should be changed. As all parties agree that the chain weighted GDPPI is now the appropriate measure of inflation, we conclude that the fixed weighed GDPPI should be replaced.

(b) An assessment of productivity gains for the economy as a whole, for the telecommunications industry to the extent data are available, and for Illinois Bell during the period that the alternative regulatory framework has been in place, and whether the adopted general adjustment factor should be modified.

The Commission's 1994 Order adopted a general productivity adjustment, or "X" factor in the price cap formula consisting of three elements: (1) a productivity differential; (2) an input price differential; and (3) a consumer productivity dividend. The productivity differential measures the difference between telecommunications total factor productivity gains and overall economy total factor productivity gains. The input price differential measures the difference between telecommunications input prices and economy-wide input prices, and the 1% consumer dividend was based on the Commission's expectation that AI would exceed the 3.3% productivity factor, and that consumers should benefit by adjusting AI's rates by this additional 1%. Alt. Reg. Order at 39. The sum of these measures is set-off against inflation to determine the size of the price change in the price index.

In 1994, the Commission set the productivity differential at 1.3%, the input price differential at 2.0% and the consumer dividend at 1.0% (Alt Reg Order at 38). This decision was based on the Commission's analysis of Ameritech's productivity and input price performance *vis a vis* the economy as a whole and its expectations for the future. Combining these figures with a 1% consumer productivity dividend, the Commission set the X factor at 4.3%. At the time of the Alt Reg Order, i.e., 1994, industry productivity and input price data were unavailable. The productivity differential and input price differential were based on a study of Ameritech Illinois' historical productivity and input price performance over the 1984-91 time period. Alt Reg Order at 21-22, 40.

AI's Position

i. Ameritech Illinois - Specific Results

AI witness Dr. Meitzen presented an updated version of the Ameritech Illinois TFP study which the Commission relied on in 1994. He testified that between 1984-91, AI's TFP growth averaged 2.2% and economy-wide TFP growth was 0.9%, for a TFP differential of 1.3%. Over the 1992-99 period, Ameritech Illinois' output growth averaged 4.6%, input growth averaged 0.5% and TFP growth averaged 4.2% annually. Based on the current BLS data referenced above, this results in a current TFP differential of 3.1% and an input price differential of 0.5%, for an X factor of 3.5%. (Am. Ill. Ex. 2.2, p. 5).

ii. Local Exchange Industry Results

To develop local exchange industry TFP results, AI witness Dr. Meitzen used the Total Factor Productivity Review Plan ("TFPRP") model, developed by the United States Telecom Association ("USTA") in conjunction with his consulting firm, which measures TFP growth for the local exchange carrier industry. The TFPRP is based on the same methodology as the Ameritech Illinois-specific TFP studies, is updated periodically and, currently, model results are available through 1998. For the 1992-1998 period, the TFPRP calculates average annual output growth of 4.7 percent, average annual input growth of 1.3 percent and average TFP growth of 3.4 percent annually for the LEC industry. Using the above referenced BLS data, the industry TFP differential is 2.4 percent, and the input price differential is 0.9%, for an X factor of 3.3%. (AI Ex. 2.2, pp. 3-4).

Ameritech lllinois compared the 1994 X factor to Mr. Meitzen's calculations and concluded that the X factor was properly set it did not otherwise assess the X factor.

Staff's Position

Staff did not provide a separate, historical assessment of how the X factor functioned during the Plan, although it addressed what the X-factor should be going-forward.

GCI/City's Position

In establishing the price index, GCI/City maintain the Commission sought to capture the "competitive outcome" in which industry productivity improvements and cost conditions are flowed through in consumer prices. It adopted the 4.3% X factor, which it subtracted from the GDPPI inflation rate to determine the aggregate rate increases or decreases under the price index plan, subject to service quality performance and exogenous factor adjustments.

The GCI/City refers to GCI/City witness Selwyn's testimony indicating that the X factor, as applied, failed to capture a reasonable portion of AI's productivity. (GCI Ex. 3.0 at 22-23.) To test the historical effectiveness of the X factor, the GCI/City state, Dr. Selwyn calculated what productivity factor would have resulted in AI earning the authorized rate of return of 11.36%. His "implicit X-factor" analysis showed that AI's actual productivity during the course of the plan was 11.06%. According to the GCI/City, this shows that the 4.3% offset has been unreasonably low and that ratepayers have not received a reasonable portion of the productivity savings achieved during the course of the plan.

GCI/City note, that the insufficiency of the 4.3% X factor is also demonstrated by AI's reported earnings of 19.15% for intrastate operations (later reduced to 18.82%) and 23.89% for total company operations for 1999. AI's and Ameritech's reported earnings, compared with FCC ARMIS data for the other Bell Operating Companies, ("BOCs"), shows a great disparity between Illinois Bell, Ameritech and other BOCs. Indeed, GCI/City claim, AI's return on rate base is almost as high or higher than the BOCs overall return on equity, and Ameritech's return on equity reported in its annual reports required by the Plan is several hundred basis points higher than the other BOCs return in every year except 1996. These notably high returns on both Illinois rate base and Ameritech stockholder equity, the GCI/City claim, are strong evidence that the X factor has been unreasonably low and that ratepayers have been paying excessive rates as a result. The GCI/City also note that the FCC has adopted a 6.5% adjustment factor, or a "rate reduction factor," as a result of the "CALLS" settlement proposed by the BOCs, including AI's parent SBC.

According to the GCI/City, the implicit X factor analysis, AI's extraordinarily high rate of return on rate base, and the fact that AI, Ameritech and SBC proposed a 6.5% rate reduction adjustment in the federal jurisdiction, all demonstrate that the 4.3% X factor was understated and must be adjusted upward. In their Joint Reply Brief, GCI/City assert that AI has achieved efficiencies well beyond the 4.3% X factor.

Commission Analysis and Conclusion

The X factor was adopted to capture the Company's productivity savings. When we established the Plan, we set cost based rates. The rate changes mandated by the Plan were directly related to the X factor and were expected to reflect AI's productivity savings. The issue before us is: Did the X factor accurately capture AI's savings?

Although AI and Staff discussed total factor productivity studies, they did not address whether total factor productivity studies produced an appropriate measure of Company savings. GCI witness Lee Selwyn was the only witness to assess the X-factor with reference to outside measures, such as reported earnings and his "implicit X factor."

We conclude that in order to assess the adequacy of the X-factor, we should review AI's earnings because it is an external measure and is directly related to whether AI's rates are just and reasonable. As we stated in the 1994 Order in ordering AI to report certain financial and earnings data, such reporting "may provide useful evaluative information. For example, unusually high reported rates of return, particularly in the face of accelerated depreciation charges, may constitute a possible early warning that the total offset in the price regulation formula has been set too low or that the pricing constraints have been otherwise ineffective." Id. at 92. The earnings data presented by Dr. Selwyn, as well as AI's annual reports to the Commission, show "unusually high reported rates of return". This evidence is persuasive and convince us that the X factor we adopted, based on total factor productivity studies, has been in adequate to maintain cost based, fair, just and reasonable rates.

We conclude that the X factor has not reflected a reasonable portion of the savings AI has realized under the Plan, and that the X factor should be modified going forward from 4.3% to 6.5%.

(c) Whether the adopted monitoring and reporting requirements should be retained or adjusted.

AI's Position

Ameritech Illinois proposes to streamline the monitoring and reporting requirements. It argues that items (1) - (6) detail the Company's financial performance and are not appropriate in a price regulation plan. The Company further points out that the stated rationale in 1994 was that high earnings could provide an "early warning" that the productivity offset may have been misspecified, but that in practice, no such use was make of these reports. AI maintains that the productivity offset was not misspecified, so no further reporting is necessary.

AI also argued that the annual infrastructure report has been superseded by the merger report required pursuant to the SBC/Ameritech Merger Order, ICC Docket 98-0555, and that no other report is necessary. In addition, AI does not object to showing that it is in compliance with Section 13-507 of the Public Utilities Act (prohibition on cross subsidy of competitive services by non-competitive services) and the aggregate revenue test, "if the Commission has found it useful." AI Initial Br. at 49.

The Company also argues that the portions of the annual report which duplicate the annual rate filing should be eliminated. These include: summary information relative to the inflation factor, exogenous changes, service quality, new services, price changes and growth by revenue baskets (items (8) - (11) and (13) - (14)).

Staff's Position

Staff notes that Section 13-506.1 (d) of the Public Utilities Act ("PUA") provides, in relevant part, that:

> Any alternative form of regulation granted for a multi-year period under this Section shall provide for annual or more frequent reporting to the Commission to document that the requirements of the plan are being properly implemented.

Staff further asserts that the information supplied by Ameritech pursuant to such reporting requirements is valuable to the Commission, the Staff, and the public in determining whether Ameritech is complying with the conditions of the Alternative Regulation Plan.

Currently, in its annual price cap filing, Ameritech is required to report on the following:

(1) total Company and Illinois jurisdictional rate base for the preceding calendar year adjusted to reflect regulatory treatment ordered in Dockets 92-0448/93-0239;

(1) total Company and Illinois jurisdictional operating revenue and expenses for the preceding calendar year adjusted to reflect the regulatory treatment ordered in Dockets 92-0448/93-0239;

(1) other income and deductions, interest charges, and extraordinary items for the preceding year (with explanations);

(1) preceding calendar end-of-year capital structure;

(1) calculated total Company and Illinois jurisdictional return on net utility rate base and total Company return on common equity;

(1) statement of Sources and Applications of Funds for the preceding calendar year;

(1) description of proposed projects and amounts to be invested in new technology (regarding the Company's $3 billion infrastructure investment) for the current calendar year and a comparison with the actual projects and amounts invested in new technologies during the preceding calendar year;

(1) calculation of the current price cap index and actual price indexes including the formulas used, the inflation factor and its source, the general adjustment factor, the exogenous factor and a description of its calculation, and the service quality component and a description of its calculation;

(1) a description of new services offered in the preceding calendar year, including the price of each and its effect on the calculation of API;

(1) demand growth by revenue basket in the preceding calendar year;

(1) summary of price changes initiated under the Alternative Regulatory Plan in the

preceding calendar year;

(1) a demonstration that Section 13-507 of the Act has been complied with during the preceding calendar year;

(1) a summary report on Ameritech's quality of service during the preceding calendar year; and

(1) a summary report on the exogenous events that affected the exogenous factor of the price cap index formula.

(See, Alt. Reg. Order, Appendix A at 7-10).

According to Staff, the reports are intended to document that the requirements of the plan are being properly implemented such that every requirement or condition of the alternative regulation plan should be addressed in these reports. Otherwise, the Commission, the Staff, and the many parties with a legitimate interest in the workings of the Plan would be unable to make an informed assessment.

According to Staff, the individual reporting requirements are also meaningful in a regulatory sense. It is necessary that AI be required to report on service quality, (item 13 above), in light of its recent, well-publicized and admitted failures in this regard. Likewise, Ameritech should be required to report on infrastructure investment, given its own commitment in the merger proceeding to continue to invest in its infrastructure. (See, Merger Order 98-0555). Similarly, Staff claims that the Commission's authority to rescind alternative regulation plans that fail to satisfy the statutory requirements for such plans, means that AI should be required to produce basic financial information, especially where, as is the case with respect to items (1)-(6) above, the information is not available from other sources. While Staff recognizes that Ameritech already files information responsive to items (8)-(11), (13) and (14) above, it suggests that a single source of information regarding Ameritech's performance under the plan, which the price cap filings do not provide is necessary and appropriate.

GCI/City's Position

GCI/City basically agree with Staff's position that the reporting information provided each year in the annual rate filing has been helpful, has to enabled the Commission to monitor that the plan is being properly applied. and that the intended benefits are realized. The reporting requirements have included reports of AI's intrastate return on rate same and return on common-equity- information that otherwise may not be readily available to the Commission and parties. . Also, GCI/City maintain that without a clear directive from the Commission to provide certain types of information, the Commission and interested parties would be unable to obtain it when needed in the future.

Commission Analysis and Conclusion

We conclude that section 13-506.1(d) of the Act requires that any company under an alternative regulation plan report the results of its operations, and that the information AI has filed has been helpful to the Commission and to interested parties. In response to AI's position that the Commission has not used the financial information provided, the Commission notes that this review proceeding is an appropriate venue to review the Company's Illinois financial performance, and that this information has been useful to the Commission in monitoring AI's financial performance even though the Commission has not previously revisited the productivity offset. We find that the financial reporting requirements should be retained.

We also accept AI's argument that the investment report required by our Merger Order be accepted as part of the alternative regulation reporting. We will retain the section 13-507 and aggregate revenue test reports and the other reporting requirements, even though they duplicate the information contained in the annual rate filing. We agree with Staff and GCI/City that it is useful to have all information in one report, and that the need to duplicate the reports in the annual rate filing is a minimal burden on the Company.

(d) The extent to which Illinois Bell has modernized its network and additional modernization plans for the near term.

AI's Position

AI witness Gebhardt testified indicates that substantial investments were made in deploying additional fiber facilities through the network. (Am. Ill. Ex. 1.1) He explained that fiber facilities improve efficiency and reliability in the transport of voice and data, and are an essential building block for providing future advanced services. Further, Mr. Gebhardt notes that AI has completed its deployment of SS7 capability, a technology which improves network efficiency and call handling processes, and provides capabilities for the Ameritech Intelligent Network platform. In addition, Mr. Gebhardt testified, the Company expended many millions to modify its network and open it to completion.

A summary of Ameritech Illinois' investments over the 1994-99 period was put into record (Am. Ill. Ex. 1.1, Schedule 3), as were its modernization plans for the future. (See, Jacobs testimony, Am. Ill. Ex. 5.0).

Staff's Position

Staff avers that AI's network modernization reports must be submitted in sufficient detail to allow the Commission to determine (a) whether and how each investment was made, (b) whether it serves to maintain the quality of Ameritech's network, and (c) whether the investment is in the interest of all of Ameritech's customer classes. According to Staff, these reports are audited by an independent third party selected by the Commission and must be expressly approved by the Commission. With these measures in place, Staff maintains that the Commission need not address anything other than the reporting and monitoring aspect of the matter in this docket.

GCI/City's Position

According to the GCI/City, there were insufficient network access lines available for installation in the latter half of year 2000, resulting in extensive delays in the installation of "Plain Old Telephone Service" or POTS. During this time, the GCI/City note, consumers waited weeks and even months for installation of a simple telephone line or repair in some areas of the state, the number of out of service complaints increased, and AI failed to return an increasingly greater number of customers to service within the 24 hour benchmark.

Despite AI's reported $3.7 billion infrastructure investment, the GCI/City notes that there has been service quality degradation. According to the GCI/City, AI's inadequate network investment has affected DSL expansion; has been one of the primary reasons for the Company's inability to comply with the Commission's installation requirements; and also served to undermine the Company's ability to provide adequate internet services. It was SBC's chairman, the GCI/City claims, who publicly attributed AI's service quality problems to inadequate investment in infrastructure. (GCI Ex. 11.0 at 68-69.) Similarly, GCI witness Charlotte TerKeurst determined that investment in network access facilities has been inadequate to keep up with demand.

GCI/City further maintain that AI's inadequate network investment is demonstrated by its use of pair gain technology, whereby up to 12 network access lines are derived from a single copper loop, which reduces data transmission speed from the 56 kilobit per second standard to 14.4 kilobits per second, making internet use unacceptably slow. GCI/City criticize AI's position that consumers who want faster data transmission speeds can order DSL or ADSL service (1) because it attempts to justify a degradation of service (2) by putting an additional expense and burden on consumers in order to obtain the quality of service they received prior to the extensive use of pair gain technology (3) in a manner that could potentially benefit Ameritech's sister company which offers DSL service on an unregulated basis.

GCI/City pointed out that Ms. TerKeurst testified that almost $1 billion of AI's $3 billion commitment was spent on just one of AI's high margin services, Project Pronto, which extends loop reach for current and future broadband services offered by an Ameritech affiliate. This, combined with Ai's extensive service quality problems, compel the conclusion that the Plan incentives did not lead to an adequate portion of the $3.7 billion investment being directed to basic infrastructure. And, in response to AI's argument that it spent "many millions of dollars" to open its network to competition, GCI/City claim that the investment was ineffective in facilitating meaningful competition.

In view of AI's service quality problems, the GCI/City maintain that the Commission should not lessen the infrastructure investment requirements or reporting. According to the GCI/City, the annual infrastructure investment reports that were ordered in the Merger docket should be relied on in determining whether the existing infrastructure investment should be increased to keep any alternative regulation plan in compliance with statutory requirements.

Commission Analysis and Conclusion

No party denies that AI spent the amounts to which it committed in 1994. However, it is clear that AI's network has not been maintained at a level sufficient to maintain adequate service quality. We find it significant that SBC chairman Whitacre publicly attributed AI's service quality problems to inadequate investment in infrastructure, and conclude that AI has not adequately maintained, let alone modernized, its network under the Alt. Reg. plan. AI argues that it spent "many millions of dollars" opening its network to competitors. Nevertheless, we note that service quality problems have also plagued AI's wholesale customers (see section *** below, McLeod, AT&T) , drawing into question the sufficiency of this investment.

(e) A listing of all services in each basket and a report of the cumulative percentage changes in prices for each service during the period the price cap mechanism has been in effect.

AI's Position

Ameritech Illinois maintains that it supplied the required list of services and the report of cumulative percentage price changes for those services. (Am. Ill. Ex. 1.0, Schedule 6). According to AI, the data demonstrate that a wide range of noncompetitive services experienced significant rate decreases over the first five-year term of the Plan. AI explains that price reductions, in general, were targeted at services where contribution levels were relatively high and where price reductions would encourage broader deployment of the Company's services. Also, the Company maintains that it attempted to avoid reductions for those services, for example the residential network access line, where it argues the price-to-cost relationship is too low today.

Staff's Position

After reviewing AI's response to this requirement, Staff is of the opinion that Ameritech's characterizations concerning actual price changes are accurate. Staff, however, does not support AI's estimate of the cumulative revenue reductions resulting from these rate reductions where Ameritech asserts that the Plan has resulted in total benefits to consumers on the order of $943 million.

According to Staff, Ameritech's revenue reduction calculations do not take into account increases in demand for services that resulted from rate reductions. Staff states that the impact of the demand stimulation is an increase in revenue and, therefore, Staff believes that the figures overstate the benefit to consumers under the Plan. As support for its argument, Staff points to Ameritech's own admission that it targeted rate reductions to those services for which demand would increase because of such rate reductions (i.e. for price elastic services). Where Ameritech believes that rate reductions would result in increased demand, its calculation of cumulative revenue reductions should reflect this increased demand.

Further, Staff notes, Ameritech continued to include revenue reductions for services declared "competitive" in its calculation of consumer benefits. Staff views AI's calculation is as follows: multiplying the mandated rate reductions in the first year ($30 million) by five, then adding that figure to the mandated rate reductions in the second year (after it has been multiplied by four); adding that cumulative total to mandated rate reductions in the third year (after it has been multiplied by three), and so on. (Tr. 396). In other words, Ameritech continued to count as consumer "benefits" the reductions in rates that did not in fact occur, or at best, occurred outside of the Plan.

According to Staff, almost all business services were subject to the Plan at its inception, and almost none are subject to it now. Revenues in the business basket subject to the Plan have actually declined from $409 million in 1996 to $18 million today. Yet it appears to Staff that Ameritech continues to count rate reductions for $391 million worth of reclassified services as "benefits" of the Plan. In Staff's view, Ameritech cannot justly claim that customers benefit from service reclassification. Although Staff was unable to provide a sufficient proxy for the actual savings received by customers, it maintains that Ameritech's estimated benefit to consumers is significantly inflated.

GCI/City's Position

According to the GCI/City, the AI list shows that in all the years of the Plan's operation, it has made no reductions to the residential network access line ("NAL") charge, which is the most basic and inelastic element of local exchange service. GCI/City state that the network access line charge is inelastic, is a prerequisite to receiving any other landline telecommunications service, (including long distance) and is paid by customers every month, regardless of whether or not they make calls on the network.

The GCI/City claim that by giving AI the flexibility to decide how rate reductions would be allocated among various services, the Plan allowed the Company to ensure that the most inelastic portion of the local phone bill never decreased while most of the benefits of alternative regulation went to high-volume customers. Not only is this pricing structure inequitable, the GCI/City maintain, but it runs counter to the Commission's policy to guard against "Ramsey pricing." (See Alt. Reg. Order at 70).

During the Plan, the GCI/City argue, AI made only modest reductions to those services in the residential basket most often used by residential customers: the Company reduced usage rates for band A (where customers place the most local calls) by only 3.85%; less-frequently placed band B calls enjoyed a higher discount of between 21% and 33%; and the major reductions, ranging from 42% to 297%, resulted from increasing the residential volume discount, which is based on total usage. Hence, the GCI/City assert, AI linked rate reductions to increased use of its system, which drastically limited rate reductions to low or moderate use customers. GCI/City pointed out that the Simplifive and CallPack packages actually increased the cost of band A and B usage for most subscribers, without the constraint of the price cap because AI characterized these packages as "new services."

GCI/City note that the Plan included certain pricing constraints such as limiting pricing flexibility to 2% of the *PCI and requiring rate reductions for each of four service baskets in an effort to insure that all classes of customers benefitted from the anticipated rate reductions. (Alt. Reg. Order at 69-70). AI's failure to reduce the NAL rate and Band A usage and its use of volume discounts to implement rate reductions under the Plan, the GCI/City claim, show that the plan failed to benefit all classes of customers and requires that the plan be modified going forward.

GCI/City also argued that GCI witness William Dunkel's corrected and revised cost of service study refuted AI's argument that the NAL rate was below cost. GCI/City assert that the evidence demonstrated that all NAL rates could be reduced by $1.30 per month, and still cover all costs. Therefore, GCI/City maintains that AI's explanation for its failure to reduce the NAL rate is not supported by the record.

Commission Analysis and Conclusion

The Commission is concerned that the rate reductions in the residential basket have been concentrated in volume discounts, and that small and moderate use residential consumers have received little benefit from the plan. We conclude that in this review proceeding we proceeding we have the opportunity to correct this imbalance, as discussed in more detail below.

(f) A listing of any services which have been withdrawn during the period.

AI's Position

To satisfy its requirement, Ameritech Illinois provided a list of all services which were grandfathered or withdrawn during the first five-year period of the Plan. (Am. Ill. Ex. 1.0, Schedule 2). In general, the Company explained that it sought to grandfather and/or eliminate services where demand was low, continued product support costs were high and/or technological advances created a better substitute service. For example, Basic 911 Type I service was grandfathered in 1996 as better, more reliable 911 service became available. At the time the service was grandfathered, only two customers subscribed. There is currently no demand for this service.

Staff's Position

Staff considers the list AI provided to be complete, unobjectionable, and as such raises no issues for this proceeding.

GCI/City's Position

According to GCI/City, the list which AI provided did not specify which were services, which were payment options, or which applied to the residential, business, carrier or other service category. As such, the GCI/City claim, the listing does not help the Commission discern the significance of the discontinuation of these services. GCI/City maintain that no issue has been raised about discontinued services.

Commission Analysis and Conclusion

Based on the foregoing discussion, we find no issue raised for this proceeding.

(g) A listing of all services which have been reclassified as competitive or noncompetitive during the period.

AI's Position

As required, Ameritech Illinois provided a list of all noncompetitive services which were reclassified as competitive over the first five-year period of the Plan. (Am. Ill. Ex. 1.0, Schedule 3). According to AI, a significant number of services -- particularly business services -- are now available from multiple providers in Ameritech Illinois' service territory. This result, AI maintains, is consistent with both the statutory construct, because alternative regulation plans only apply to noncompetitive services, and with the policy underpinnings of price regulation, which is intended to determine prices where market forces do not exist.

Staff's Position

Ameritech has produced the required list which Staff considers to be accurate to the extent that it correctly describes which services have been reclassified. But, Staff argues, the list does not provide any insight as to the impact on the Plan resulting from reclassifying a service as competitive. It is Staff's opinion that Ameritech's reclassification of services has significantly weakened the Plan. Staff discussion on the impact of competitive reclassification appears in a subsequent section of this Order.

GCI/City Position

GCI/City observe that while AI witness Gebhardt's direct testimony provides the Commission with a list of services which AI reclassified as competitive since the inception of the plan, he did not further explain that many of those reclassification have not withstood Commission scrutiny. The GCI/City note that some of these reclassifications, (including business usage for band B and C calls and operator assisted and calling card usage and usage originating in MSAs 1,2,3,6,7,9 and 15), were reversed by a Commission order in October 1995, that was later affirmed by the court. Illinois Bell Telephone Co. v. Illinois Commerce Commission, 282 Ill.App.3d 672 (3d Dist 1996). While AI also lists a 1998 reclassification for all business services in Illinois and for residential service in 19 exchanges as competitive, the GCI/City note that a Commission-initiated investigation into the propriety of those reclassifications, i.e., Docket 98-0860, is pending.

GCI/City note that services classified as competitive are no longer subject to the pricing constraints of the plan, nor are revenues from the services included in the calculation of the service quality adjustment. According to the GCI/City, the reclassifications pursued by AI during the plan, removed about 35% of its revenues from the Plan, and left the Plan significantly less effective in both retaining the benefits of productivity for consumers and protecting consumers from market abuse.

GCI/City point out that AI increased the rates for many of the services reclassified as competitive, and that the Commission has reversed many reclassifications after hearings. GCI/City argue that these rate increases have been a major contributor to AI's high earnings levels. GCI/City suggest that the incentives to reclassify services as competitive should be reduced.

As part of alternative regulation, GCI/City propose that the Commission require the Company to maintain appropriate records to enable the Commission and the parties to review the relevant data to assess the effect of reclassifications on rates and on the operation of the Plan. The report should include the data Staff requested, but was unable to obtain from the Company during this review proceeding, i.e., the revenue received from rate increases for reclassified services plus unrealized savings that would have occurred had the services remained under the price cap mechanism. Additional important information is whether the reclassification was subject to Commission review and ultimately changed.

Commission Analysis and Conclusion

The Commission finds that although AI produced a listing of services reclassified as competitive since the inception of the Plan, the list provided fails to provide the Commission with key information. However, other parties, notably Staff and the GCI/City witnesses, have informed the record about the consequences of AI's reclassifications. We believe that the scope of reclassifications, along with the numerous and contentious dockets opened to review the reclassifications and the attendant rate reduction orders, have raised serious questions about the incentives to reclassify contained in the Plan and the effect of reclassification on the benefits expected from the Plan. Issues with respect to reclassification will be explored further in a later section of this Order.

(h) A summary of new services which have been introduced during the period.

AI's Position

Ameritech Illinois provided a list of the new services which it introduced during the first five-year period of the Plan. (Am Ill. Ex. 1.0, Schedule 4). It claims that new services were an important source of revenue for the Company and are producing about $200 million in annual revenues. Specifically, it identified "Privacy Manager", which allows customers to pre-screen their calls to eliminate telemarketing or other unwanted intrusions. Further, AI witness Gebhardt testified that innovation "occurs in the areas of pricing, packaging and call plans, not new services *per se*." (AI Ex. 1.1 at 51).

Staff's Position

Staff does not dispute the completeness of the list of new services Ameritech has provided. It is of the opinion, however, that a number of the services described by Ameritech as "new" are not so in reality. In Staff's view, the great majority of the revenue Ameritech has realized from new services (over 90%) is derived from so-called "optional calling plans," which are little more than repackaging of Band A, B, and C residential usage at differing rates. The significance of this repackaging, according to Staff, is that it provides the rationale for Ameritech to place these optional calling plans in the "Other Services" Basket, rather than the "Residence" Basket.

These services, Staff claims, are all basic residential services, which the vast majority of customers need and use regularly. To classify them as "Other" rather than "Residential" makes little sense, and benefits no one but Ameritech. In authorizing the current Plan, Staff asserts, the Commission surely expected some degree of innovation in the products and services offered, not simply in the novelty of marketing of existing products and services.

Staff considers improper classification of this sort to be a problem because shifting what is clearly basic residential service revenue to the "Other Services" basket, compromises the ability of the price cap plan to provide reductions in rates for residential services. The current four-basket system was established to limit the likelihood of discrimination against residential customers. As more revenue is transferred out of the Residence Basket to the Other Services Basket, Staff contends, more rate reductions will also shift to the Other Services Basket. Since there have been no reductions for local calling plans in any of the annual filings under the Plan, Staff believes it fair to conclude that non-essential services are receiving rate reductions that otherwise would have been earmarked for basic residential services. To remedy this unfair situation, Staff recommends that local calling plans be moved out from the Other Services Basket to the Residential Basket.

GCI/City's Position

According to the GCI/City, the AI list of new services lacks sufficient detail for the Commission to draw any conclusions about the nature of the new services or whether the plan has led to more new services than would have been offered in the absence of alternative regulation. The listing fails to provide a description of the services or to indicate whether the new services fall in the business, carrier, residential or other category.

Some of the "new services" such as the 1995 usage discount plans, the 1996 ValueLink offering, the 1997 residence local call plans, and the 1999 Anytime rate calling plan, GCI/City contends, merely represent different billing options for existing services. GCI/City note that Ms. TerKeurst's explanation that a bundle of services that are already available to customers on a stand-alone basis "is properly labeled as a restructured service because it modifies the method of provisioning and charging for the same services previously available." (GCI Ex. 11.0 at 61). Such "restructured" services, these parties maintain, do not represent innovation or an expansion of service options.

GCI/City note that in "repackaging" local usage, AI increased the rates for Band A, and increased the average rate for Band B calling in its Simplifive and CallPack programs. (See Docket 00-0043, Order at 31-32 (Jan. 23, 2001)). The only calling plan rate lower than the regularly tariffed rate was for Band C usage. Band C tariffed usage rates were increased from 4 to 10 cents per minute after their competitive reclassification, compared to the calling plan rates of 5 cents per minute and 10 cents per call. These "new services" were really rate increases for all but a subset of consumers with a particular calling pattern. (Id. at 33) Further, these parties agree with Staff's view that AI did not show innovation in products or services and that its marketing practices. at least with regard to the Simplifive plan, have raised Commission concern. See ICC Docket 00-0043, Order (Jan. 24, 2001).

GCI/City also point out that AI witness Gebhardt admitted that telecommunications innovation stems from the switch vendors, and not from the local exchange carrier. They assert that this proves that the Plan has not affected or encouraged innovation in products or services.

Commission Analysis and Conclusion

AI provided the list of services it considers "new" and that were treated as new under the Plan. Other parties, such as Staff and GCI/City, have convincingly argued that these "new services" are in fact "repackaging" and have resulted in price increases for services that were originally placed in the residence basket. We are concerned that the prices for the residential calling plans are higher for most rate categories, and that these increases would not have been permitted under the Plan but for the "new services" designation. We find that AI has used the new services provision of the Plan to undermine the residential basket price protections. The Commission notes that it will further examine the issues raised here in section V.E of this Order which addresses the basket structure and new services designation.

(i) Information regarding any changes in universal service levels in Illinois Bell's service territory during the price cap period.

AI's Position

Ameritech Illinois provided information regarding service levels during the period that the Plan was in effect. Based on data from FCC reports, telephone subscribership ranged between 93.6% and 93.8% for the State of Illinois for the four-year period immediately prior to implementation of the price cap plan. For the five years of the Plan's operation, the comparable data ranged between 91.8% and 93.6%. AI witness Gebhardt acknowledged that "Illinois' standing in comparison to the rest of the nation appears to be low, whether one looks at current or historic data." According, to AI, data are not available for Ameritech Illinois' service territory specifically. (Am. Ill. Ex. 1.1, pp. 62-63).

Although the data suggest a decline in universal service over the last five years, AI maintains that there is no evidence that this problem is related to the Plan in any way. If anything, AI claims, the Plan has resulted in price reductions, which logically would have had a positive impact on subscribership. Furthermore, AI maintains that its rates generally are low relative to those of incumbent LECs in other states. In light of these considerations, AI contends there must surely be something other than price that is driving the results.

AI states that a study has been commissioned by Ameritech Illinois, the ITA and UTAC with the involvement of Commission Staff, to determine what is causing these results. This study should be available in the relatively near future. If the Commission were to ultimately conclude that there is a subscribership issue in Illinois, a separate proceeding could be established to determine what the problem is and evaluate the possible solutions.

Staff's Position

According to Staff, Ameritech has provided the requested information on this issue. (Ameritech Ex. 1.1 at 68-69).

Staff informs that telephone subscribership (percentage of households with telephones) declined in Illinois between 1995 and 1999, while it has increased nationwide. Even though subscribership increased in 2000, Illinois' levels are still less than the national average. This problem, however, cannot be attributed conclusively to the Plan in Staff's opinion, inasmuch as other Illinois incumbent local exchange carriers ("ILECs") have lower subscribership levels in their service territories than Ameritech has in its territory. Moreover, the Commission, the Staff, and incumbent carriers, including Ameritech, have joined together to study the causes of low subscribership in Illinois, and address them to the extent possible. Staff, therefore, is of the opinion that Ameritech is in compliance with this requirement and that this is not an issue for this proceeding.

GCI/City's Position

GCI/City note that AI only provided the FCC data on Illinois telephone subscribership despite the fact that the 1994 Order required universal service information "in Illinois Bell's service territory." Alt. Reg. Order at 95. The FCC data, the GCI/City assert, show a decline in telephone penetration during the course of the plan from 93.6% in 1994 and 1995 to 92.2% in 1997 to 91.8% in 1999. In his testimony, AI witness Gebhardt admitted that Illinois' standing in comparison to the rest of the nation appears to be low, whether one looks at current or historic data.

GCI/City witness Dunkel provided more specific universal service information, showing that in 1999, (the last year for which annual information is available), Illinois reached a low point of 91.8% telephone penetration. Mr. Dunkel demonstrated that telephone penetration rates in Illinois have declined during the course of the Plan, and that the FCC singled out Illinois as the only state with a "significant decrease" in penetration from 1983 to July, 2000. Mr. Dunkel also indicated that Illinois is 2.4% below the national penetration rate, whereas in 1995 it was only .3% away from the national average.

GCI/City maintain that AI provides 85% of the access lines in Illinois and accordingly the Illinois penetration rate shown in FCC data could reasonably be linked to AI's penetration rate. The 1.8% decline from 1995 to 1999 substantially exceeds the 1.4% change Mr. Gebhardt admitted was statistically significant, GCI/City argue, and should be a matter of concern to the Commission in this evaluation of alternative regulation

Whereas AI offers no definitive explanation for the decline in penetration rates, GCI/City suggest that the repackaging of non-competitive local usage in calling plans at higher local rates, the aggressive sales techniques for optional, vertical features, and poor quality of service, are easily understood reasons for both the disconnection for lack of payment, and consumers' avoidance of AI's system altogether.

GCI/City responded to AI's position that the Plan probably does not affect universal service, that its prices have decreased under the Plan and that its rates are "generally low compared to those of [other] incumbent LECs." GCI/City stated that an FCC survey of rates in 95 cities across the country shows that AI's rates, including usage, are higher than two-thirds of those cities. They also pointed out that in 1999, 187,847 customers lost service due to non-payment, and that AI averaged 40,000 Lifeline customers.

Commission Analysis and Conclusions

We are concerned that the record in this docket does not contain universal service data specific to Illinois Bell, as required by the 1994 Alt Reg Order. Failure to provide this information hampers our ability to determine whether universal service has declined during the course of the Plan. Although GCI/City argued that AI's practices may have led to the decline, w e find that these conclusions are not sustainable without an extensive and comprehensive analysis. To this end, as both AI and Staff inform us, there is a study underway to ascertain the real cause of this problem and we will proceed further on that basis.

(j) Whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals?

Commission Analysis and Conclusions

At this juncture the Commission's focus in this Order will now be centered on the particular statutory goals and expectations under which we authorized the inception of the current Plan. Our analysis here maintains a historical perspective as we assess how the Plan has functioned and begin to explore the type and extent of modifications needed going forward.

III. THE STATUTORY CRITERIA AND GOALS

When approving Ameritech Illinois' Alternative Regulation Plan in 1994, the Commission made seven affirmative findings under Section 13-506.1(b) and "consider" six additional policy goals set out in Sections 13-506.1(a) and others listed under 13-103 of the Act. The Commission concluded that, an overall assessment as to whether the Plan "constitutes a more appropriate form of regulation" is required. (Alt Reg Order at 180). In determining that the Plan met these regulatory criteria in 1994, the Commission necessarily expressed expectations as to how they would be met. (Alt Reg Order at 179-192). Here we will proceed to examine the Plan's performance in the context of those expectations and statutory requirements.

In this section, we observe that a number of the provisions to be examined either overlap or are otherwise related and, hence, it is appropriate in these instances that they be considered jointly.

1. Has the Plan Produced Fair, Just, and Reasonable Rates

Authority: Sections 13-103; 13-506.1(a); 13-506.1(b) and the Alt Reg Order.

In the Alt Reg Order, the Commission conducted a traditional earnings analysis, based on a 1991-1992 test year, to establish an appropriate starting point for noncompetitive service rates under the Plan. In response to AI's request for price regulation, the Commission designed a price index in an effort to regulate prices so that rates remained fair, just and reasonable over time. The Commission found that this index would continue to produce reasonable rates provided it appropriately reflected the impact of economy-wide cost changes which should be flowed through to consumers, less an appropriate productivity offset. The Commission further found that, by linking price changes to a price index, the Plan would "protect ratepayers from the impact of competition and management error." The Commission also expected that, given the magnitude of the productivity offset which had been selected, both the "real" and actual prices of noncompetitive services were likely to decline. (Alt Reg Order at 186).

In this review proceeding, which the Commission mandated in the 1994 Alt Reg Order, we assess whether the price index did in fact maintain fair, just and reasonable rates.

AI's Position

AI maintains that noncompetitive service rates performed precisely as the Commission expected. The price index included appropriate measures for both inflation (GDPPI) and the productivity offset, which the Company claims flowed through to consumers all of the productivity gains achieved by the Company during the 1995-99 period. As the Commission had predicted, AI maintains, the real and actual prices of noncompetitive services fell significantly over the 1995-1999 period. AI maintains that under the Plan its rates continue to be just and reasonable.

In this proceeding, Ameritech Illinois provided external benchmark comparisons to further support the reasonableness of its noncompetitive service rates, referencing the standard of "affordability," which is set out in Section 13-103(a) of the Act. By comparing rate changes under the Plan to both the Consumer Price Index and changes in wage levels over the 1994-99 period, the Company claims to have demonstrated that its noncompetitive rates are significantly more affordable today than they were in 1994. AI maintains that its rates are also lower than those of other telephone companies, both in Illinois and nationwide, and are comparable to those of its Illinois competitors.

According to AI, the meaning of the term "fair, just, and reasonable" under Section 13-506.1 must be considered within the context of the overall purpose of the statute and the Commission's 1994 Order. AI asserts that Section 13-506.1 of the Act clearly empowers the Commission to substitute alternative forms of regulation for rate of return regulation in toto:

> Notwithstanding any of the ratemaking provisions of the Article or Article IX that are deemed to require rate of return regulation, the Commission may implement alternative forms of regulation in order to establish just and reasonable rates for noncompetitive telecommunications services including, but not limited to, price regulation, earnings sharing, rate moratoria, or a network modernization plan. Section 13-506.1(a). (Emphasis added).

A plain reading of the statute, AI claims, shows that "just and reasonable" rates are based on and measured against something other than traditional rate of return principles. To assert otherwise, AI claims, is to devise a circular proposition: i.e., the Commission can approve alternative forms of regulation, but only if they produce precisely the same rates as a traditional rate case. Interpreting the statute this way, AI claims, would be nonsensical and outside the accepted canons of statutory construction.

AI asserts that the incentive mechanisms which lie at the heart of price regulation -- and which deliver benefits to consumers in the form of improved efficiency, investment in the network, and innovation in services -- are based on the premise that there is no ceiling on earnings. Indeed, by subjecting itself to price regulation, AI maintains, it "assumed the risk" of earning less than a reasonable return on equity and rate base, in exchange for the "opportunity" to earn in excess of what would typically be authorized in a rate of return environment. This was the understanding in 1994. (See, Alt Reg Order at 7-12, 181-82.). Further, AI points to Staff witness Dr. Staranczak's testimony as additional support:

> "Under alternative regulation subscribers receive a guarantee that their overall rates will rise less than general inflation while Ameritech Illinois gets the opportunity to earn higher returns. If Ameritech does indeed earn higher returns under alternative regulation this should not be interpreted as a failure of the Plan but recognized as one of the possible outcomes that was anticipated." (Staff Ex. 2.0, pp. 4-5).

The assertion that high earnings might raise a "warning flag" that the terms of the Plan may have been too favorable to the utility, must also fail, according to AI. Such "warning flags" it contends, do not translate into rate cases unless the record demonstrates that the price index seriously malfunctioned. AI contends that is not the situation here where the price index was set properly, AI implemented the required rate changes, and there is no evidence showing the resulting noncompetitive service rates to be unreasonable. Simply because the Commission required the Company to report earnings data to provide an "early warning" that the index was misspecified says nothing about reinitializing rates AI claims, particularly where as here, the index worked properly. And, the Commission's expression of a willingness to reconsider earnings sharing also says nothing about reinitializing rates as even earnings sharing plans assume that earnings will exceed what would result from a conventional rate case.

Further, the contention that an earnings analysis must be performed for Ameritech Illinois' total intrastate operations is incorrect, as a matter of law, according to the Company since both Section 13-506.1 and the Commission's 1994 Order clearly limit the Plan to noncompetitive services. Contrary to GCI witness TerKeurst's assertions, neither Section 13-506.1(a) (which authorizes the Commission to adopt earnings sharing), nor the "public interest" standard in subsection (b)(1) extend the application of the statute to competitive services. Similarly, the Commission's 1994 Order expressly excludes competitive services from the operation of the Plan:

> Price regulation directly ensures that noncompetitive rates will remain just and reasonable, while market forces will control competitive service prices and earnings. (Alt Reg Order at 187.)

According to AI, the Plan cannot reasonably be indicted based on service rates and earnings to which it was not subject in the first place. The outstanding issues associated with service reclassifications, AI contends, should be and will be, resolved in other proceedings, such as Docket 98-0860 (competitive classification of certain business services).

Thus, AI argues, even if the Commission were to use an earnings analysis to evaluate whether Ameritech Illinois' rates are just and reasonable -- which it should not –such an analysis would have to be limited to noncompetitive services. AI asserts to have demonstrated that its 1999 earnings on noncompetitive services were only 5.55%, well below Ameritech Illinois' weighted cost of capital under either Staff's analysis or the Company's. According to AI, no party either disputed the mechanics of this allocation methodology or demonstrated that the results were in any way unreasonable. Indeed, AI notes Staff witness Hoagg's testimony wherein he stated that he that he would only be concerned if Ameritech Illinois' noncompetitive services were generating extremely high earnings, over an extended period of time, and, even then, only if further investigation revealed that these earnings were inconsistent with the policy underpinnings of price regulation. (Tr. 1223-26). None of these factors apply here, says AI.

To the extent that GCI/City witness Dr. Selwyn and Staff witness Marshall reject the Company's noncompetitive service earnings analysis, on grounds that jointly used plant and common costs cannot be meaningfully allocated between competitive and noncompetitive services, AI claims they are wrong. According to AI, jointly used plant and common costs have been separated between the state and interstate jurisdictions for ratemaking purposes for decades through the separations process. Regulated costs are routinely separated from unregulated costs to comply with the FCC's Part 64 requirements and Part 711 of this Commission's rules. Common costs are routinely allocated between competitive and noncompetitive services under the Aggregate Revenue Test to comply with Section 13-507 of the Act for ratemaking purposes. (See, Illinois Bell Telephone Company v. Illinois Commerce Commission, 203 Ill. App. 3d 424, 561 N.E.2d 426 (2^{nd} Dist. 1990); See also, Order Docket 89-0033 (Remand), adopted November 4, 1991, at 200-203). In fact, AI notes that professional economists testifying in the 1994 proceeding, including Dr. Selwyn himself, proposed allocation methodologies to separate competitive and noncompetitive service earnings. (Am Ill. Ex. 1.3, pp. 24-25). The Company claims that its analysis is based on essentially the same approach as the Aggregate Revenue Test and provides a valid basis for determining noncompetitive service earnings.

So too, AI maintains, the GCI/City contentions that the Company's earnings demonstrate that the Plan was "mis-specified" are not supported by the record. To the contrary, AI maintains, Dr. Meitzen's analysis showed that the X factor was too high over this period. As such, AI asserts, this means that noncompetitive service customers received more benefits than they were entitled to, not fewer.

The City claims that the Company's earnings cannot be explained by improved productivity are proved wrong by the record, AI contends. To be sure, Ameritech Illinois' total factor productivity growth rate increased from 2.2% over the 1984-91 period to 4.2% over the 1992-99 time period. Thus, AI notes, it almost doubled. Furthermore, this data represents growth in TFP; that is, even if it had remained at the 2.2% level, the Company would still be increasing its productivity year-over-year by 2.2%. The fact that the 3.3% overall X factor did not change -- which the City of Chicago relies on for its statement -- is a function of the fact that the Commission overstated the Company's future input price performance in 1994 and the parties' unanimous proposal to shift to an industry-wide TFP figure. It does not, AI asserts, represent stagnant productivity performance.

AI would dismiss as untrue the CUB and the AG contentions that it would not have achieved these earnings in a competitive industry. AI witness Dr. Avera explained, that this was a period of record economic growth and record corporate profits. (Am. Ill. Ex. 8.0, pp. 8-10). The evidence shows that companies in fully competitive industries reported earnings of which, in CUB's words, Ameritech Illinois "can only dream". For example, AI notes that in 1999, Quaker Oats, General Mills and Campbell Soup outstripped Ameritech Illinois' return on equity by over 13 thousand, 20 thousand and 25 thousand basis points, respectively. (Am. Ill. Ex. 1.4, p. 28). It is a fiction, AI contends, that the "reasonable return" produced by conventional rate case analysis bears any necessary relationship to what actually transpires in competitive markets. It is a necessary fiction in the world of rate of return regulation, but it should not be confused with reality.

AI notes that both CUB and the Attorney General rely on Ms. TerKeurst's comparison between the earnings of the major BOCs over the 1990-99 period, - based on ARMIS reports to the FCC - in order to argue that Ameritech Illinois' profitability greatly exceeded that of its peers. AI disputes the validity of this comparison. The record shows, AI contends, that it treated certain industry-wide accounting changes (i.e., FAS 106, FAS 112 and FAS 71) differently for ARMIS reporting purposes than did the rest of the industry. As a result of this anomalous accounting treatment, Ameritech Illinois' total stockholder equity had dropped by 50% by 1994-95, which, in turn, artificially inflated its "earnings" relative to the other BOCs. AI points out that Ms. TerKeurst herself agreed that no meaningful comparison can be made between companies' earnings unless the underlying data is stated on a consistent basis. (Tr. 2174-75).

Ameritech Illinois does not dispute the fact that other provisions of the Public Utilities Act provide the Commission with "just and reasonable" authority over competitive service rates i.e., Sections 9-250 and 13-505(b). It asserts, however, that nothing in the Commission's 1994 Order suggests that competitive service rates were to be the subject of this proceeding.

For services properly classified as competitive, AI maintains, the issue of "just and reasonable" rates is far more complex than the earnings review on which GCI is relying. To be sure, AI contends, any regulatory restrictions on competitive service pricing should apply even-handedly to all providers of that service. This has been the Commission's practice to date and IXCs and CLECs have routinely been exempted from rate of return regulation in their certificate application proceedings. Thus, before embarking on any analysis of Ameritech Illinois' competitive service rates, AI maintains, the parties would have to address what standard other than earnings would be used to determine "just and reasonable" rates. And, in order to establish industry-wide pricing rules, IXCs and CLECs would have to be provided notice and an opportunity to participate. No such notice, AI claims, was issued in connection with this proceeding.

Finally, AI asserts, even if competitive service rates were at issue in this proceeding -- which they are not -- there is no evidence that they warrant a $1 billion rate decrease. AI notes that only "some" of them have been the subject of rate increases. Ameritech Illinois believes that these rate changes were appropriate in the marketplace and as to the remaining services whose rates have not changed, there is absolutely no evidence that their rates are too high. The mere fact that Ameritech Illinois' competitive services generate higher earnings than noncompetitive services reflects long-established pricing policies and says nothing about their reasonableness: they are competitive largely because they are profitable and profit margins attract competitors. Given the poor returns generated by noncompetitive services (5.55%), Ameritech Illinois' financial viability has depended on and continues to depend on the fact that competitive services in aggregate earn substantially above its authorized return.

Staff's Position

Staff maintains that the most significant regulatory and statutory goal which an alternative regulation plan must meet is to guarantee just, reasonable and affordable rates for non-competitive services. According to Staff, alternative regulation plans serve this desired end by regulating the price of those services as opposed to regulating a company's earnings.

Staff asserts that Ameritech Illinois' noncompetitive rates today are just and reasonable. Its supporting analysis is quite simple:

> "If rates were set at a just, reasonable and affordable level in 1994, and thereafter declined, notwithstanding modest levels of inflation, it stands to reason that such rates are now a fortiori just, reasonable and affordable." (Staff Init. Brief at 30).

Staff notes that the Commission should not assume, however, that it is in complete, or even substantial, agreement with the Company. While Ameritech might suggest that the incentive mechanisms which underlie the fundamental superiority of alternative regulation vis-à-vis rate of return ("ROR") derive from, and depend on, an absolute absence of a ceiling on earnings under alternative regulation, Staff clearly disagrees. This type of "sky is the limit" view on earnings, Staff maintains, is simply unsupportable.

Staff believes it has well-demonstrated that the proper standard to be applied under alternative regulation is not the imposition of rate levels associated with rate of return regulation, but rather an evaluation of whether the Plan produces affordable, just, and reasonable rates – a price performance analysis. To the extent that AI would contend that an earnings analysis has no place in an alternative regulation environment, i.e., that any level of earnings produced by a plan are acceptable, and that any rates produced by a plan are, by definition, just and reasonable, it is wrong.

According to Staff, the statutory fair, just and reasonable rate standard places upper and lower limits on acceptable rate levels under an alternative regulation plan, and earnings levels associated with those rates. For a variety of reasons, the "zone of reasonableness" of rates is broader and more elastic under alternative regulation than under rate of return regulation. This is an inherent part of the alternative regulation "compact" and reflects such realities as increased competitive entry, generally increased risk for the regulated firm, and the potential for increased benefits for all stakeholders, notably consumers. Nevertheless, Staff asserts, the zone of just and reasonable rates under alternative regulation is far from being unlimited.

It is bounded on the lower end, Staff explains, by considerations of financial integrity of the regulated company, and its attendant ability to deliver appropriate levels of service availability and quality. To illustrate this concept, Staff assumes that Ameritech's financial condition had deteriorated during the Plan to a degree that threatened its ability to provide adequate service to consumers. There can be no doubt, Staff contends, that in this situation, the Commission's statutory responsibilities would require it to intercede by adjusting prices and/or key plan parameters to forestall or ameliorate significant adverse consequences.

The zone of reasonableness, Staff asserts, is bounded on the upper end by earnings levels that clearly exceed those that could be explained by enhanced cost effectiveness, and technical and market progressiveness of the regulated company. Beyond this bound are earnings levels associated, at least in part, with such things as significant misspecification of Plan parameters, misapplication of the Plan, or behavior that successfully defeats the overall effectiveness of an alternative regulation plan.

These bounds and the fair, just and reasonable standard under alternative regulation are not readily susceptible to prior or precise quantification Staff contends. To achieve the desired end, requires informed regulatory judgement and analyses. This does not, however, diminish the importance of these bounds, or call into question their existence. Since prices alone do not provide directly the required information, earnings appropriately and necessarily are used as a proxy indicator. This is the major role of earnings analyses in any review of an alternative regulation plan.

Having applied its judgment, Staff concludes in this proceeding that Ameritech's rates and related earnings are not outside the zone of reasonableness, either on the low or high side. It must be recognized however, Staff claims, that prices and associated earnings outside this zone might have occurred, and there was no assurance in 1994 against such a result. Similarly, it is conceivable that this might still occur in the future under an extension of the alternative regulation plan, despite the expectations or intentions of the Commission, Ameritech or other parties.

For this reason, Staff recommends that an extension of the plan should provide for a review comparable to this proceeding, to be concluded no later than five years from the date of extension of the Plan. An analysis of Ameritech's earnings, as well as its price performance, Staff maintains, should also be an integral component of that review.

GCI/City's Position

GCI/City argue that the approach advanced by some parties, that just and reasonable rates can only be assessed by referring to whether the price index rate changes were made creates a circular analysis, with no objective measure.

According to GCI/City, the fact that some prices decreased as a result of the Plan, does not show anything other than that the mechanics of the plan were followed and operated as intended to decrease rates. (AG Initial Brief at 24.)

GCI/City claim that the rates currently being charged under the Plan are *not* just and reasonable based on the analysis that GCI/City witness Smith performed of the Company's pro forma income statement and the hundreds of data requests he reviewed in order to assess the earnings of AI under the price cap plan and to propose adjustments. His work, CUB contends, showed an AI intrastate return on equity of a staggering 43.08% -- nearly four times the authorized return on equity established by the Commission in the Alt Reg Order. On the basis of Mr. Smith's calculations, GCI/City claim that AI is currently overearning by approximately $956 million for AI's intrastate operations.

In addition to referring to the Company's 43.08% return on common equity derived by Mr. Smith, GCI/City cited the Company's earnings as reported by the Company during the course of the Plan to show that its rates have not been just and reasonable under the Plan. Referring to the Annual Reports filed as part of the Plan, they cite the following returns:

	AI's Calculation of Return on Rate Base	AI's Calculation of AI's Return on Common Equity
1995	9.43%	20.56%
1996	10.53%	18.89%
1997	14.25%	22.93%
1998	13.92%	23.97%
1999	19.15%	29.29%
2000	23.80%	28.60%[1]

GCI/City point out that the Company's own figures reflect an astounding 29.29% return on common

[1]These figures were reported by AI on March 30, 2001, and the Commission takes administrative notice of the report.

equity or more than double the cost of common equity approved by the Commission in 1994 and recommended as reasonable in this docket.

GCI/City also cite the cost of capital analyses prepared by AI witness Dr. Roger Ibbotson and Staff witness Alan Pregozan in support of their position that AI's earnings under the Plan have been excessive. Both AI and Staff presented testimony on the return investors expect, based on the market cost of capital. AI's witness, Roger Ibbotson, recommended:

Overall, weighted return on rate base:	10.58% - 11.21%
Return on common equity:	11.86% - 12.71%.

Dr. Ibbotson's analysis reflected a common equity ratio of 75.09%. AI Ex. 6.

Alan Pregozen testified for Staff. He recommended:

Overall return on rate base:	10.52%
Return on common equity:	11.80% - 14.40% (with a midpoint of

Staff Ex. 13. GCI/City maintain that these recommendations constitute record evidence of investors' expectations and required return on capital, and form one part of the "zone of reasonableness" analysis.

The second part of the zone of reasonableness test should consider the testimony of Staff and GCI/City witnesses who analyzed AI's overall financial performance for 1999. After making various adjustments, which will be discussed later in this Order, they reached the following conclusions:

Results of AI's Operations 1999

GCI/City Return on Rate Base	Staff Return on Rate Base	GCI/City Return on Common Equity
28.49%	26.7%	43.08%

Although Staff argues that its assessment of AI's earnings is that they are acceptable, GCI/City maintain that the returns, which are two and a half times higher than the AI and Staff cost of capital witnesses testified was required, demonstrate that AI's earnings under the Plan have become unacceptably high and have resulted in unfair, unjust, and unreasonable rates. GCI/City argue that rates must be reset in order to comply with section 13-506.1 if alternative regulation is continued.

PARTIES' RESPONSES TO OTHER PARTIES

AI asserts that rates are just and reasonable because annual overall revenue reductions have been passed through each year since the inception of the price cap plan and the revenue reductions passed through to consumers under the plan exceed what might have occurred under rate of return regulation. In response, GCI/AG note that these reductions have not been sufficient to keep AI's earnings within reasonable levels, confirming that the AI's rates declined far less than the Company's actual costs.

AI argues that the Commission's examination of the justness and reasonableness of its rates should be based on an "affordability" analysis that compares telephone rates with the changes in the consumer price index ("CPI"), wage levels and the rates of other local exchange carriers, on the theory that customers are more interested in the price they pay relative to the value they attach to the service. GCI/City note that AI chose a comparison of rates of other LECs, and not competitive carriers, for purposes of defending the Company's rate levels. Such is the case, they claim, because there is insufficient competition in the local market to provide any other comparison and because resellers derive their prices from AI's wholesale prices to them. Because AI is still the monopoly provider of residential local telephone service with over 95% of the access lines, they assert, a comparison of prices of competitors is meaningless.

GCI/City further maintain that examining other LECs' rates is a poor criterion for measuring the justness and reasonableness of AI's rates. As noted by GCI/City witness TerKeurst, AI is one of the lowest cost incumbent LECs in the nation and AI's earnings were are also some of the highest among incumbent LECs. Given its lower costs and higher earnings levels, it is reasonable to expect that AI's rate would be lower than those of other incumbent LECs. Moreover, an FCC survey of rates in 95 cities across the country shows that AI's rates, including usage, are higher than the rates in two-thirds of those cities. GCI/City believe that the criterion of "affordability" requires an examination of the Company's costs and whether they show a fair balance between ratepayers and shareholders.

In response to AI's argument that alternative regulation is based on the Company's opportunity to earn more than an authorized return, Staff and GCI/City argue that there is no provision in the Alt Reg Order or in Section 13-506.1 of the Act to suggest that alternative regulation includes an open-ended right to unlimited, excessive earnings. GCI/City claims the Alt Reg Order includes numerous provisions that reflect the Commission's desire to monitor the Plan and the Company's earnings in order to assess the Plan's performance. They point out, for example, that the Commission noted that its decision to exclude earnings sharing from the Plan is not to be construed as a rejection of all earnings sharing mechanisms of the future. The Commission further stated that it would in future review proceedings, entertain evidence and argument of policy considerations for the provision of some forms of earnings sharing in a revised plan. (See Alt Reg. Order at 51).

AI argues that the statutory requirement that rates be fair, just and reasonable is limited to noncompetitive services and that it has shown that the return on its non-competitive services is only 5.5%. In response, GCI/City refer to Staff witness Judith Marshall's testimony that AI's study lacks a proper foundation. (Staff Ex. 4.0 at 4-6). Ms. Marshall pointed out that in December, 1999, AI representatives told Staff that AI was unable to provide a breakdown of earnings between competitive and noncompetitive services because there was no generally accepted methodology to allocate embedded costs between competitive and noncompetitive services. Ms. Marshall found AI's newfound study to be arbitrary and concluded that there was no relationship between the revenues used by AI in its "study" and the embedded cost of service. She also pointed out that there is no relationship between long run service incremental costs (LRSIC) and the embedded cost of providing service. She concluded that "there is no reliable method of calculating AI's earned returns on non-competitive services." Staff Ex. 4.0 at 6.

GCI witness Charlotte TerKeurst and City witness Lee Selwyn concurred in Ms. Marshall's analysis. Further, GCI/City noted that AI changed its return on noncompetitive services from 1.64% to 3.88% to 5.55% during the course of this proceeding. (Compare AI Ex. 1.1, Sch. 7 and AI Ex. 1.6 at 2-3.) These changes show the unreliability of AI's methodology and that its figures cannot be relied upon.

Further, GCI/City claim, all of AI's local and intraLATA services are furnished using a common set of network infrastructure and other corporate resources and that it is impossible to separate the costs attributable to competitive services as AI has tried to do. They refer to Dr. Selwyn's testimony that the FCC has concluded that it is not possible to develop jurisdiction-specific estimates of total factor productivity because no economically meaningful separation of state and interstate inputs could be made. This same reasoning applies to services labeled as competitive and noncompetitive here. And, because the Commission no longer requires detailed cost studies to support "competitive" services, GCI/City claim that it has no adequate means of determining whether AI is over allocating costs to noncompetitive services and thereby depressing the noncompetitive rate of return, while under allocating costs to competitive services.

GCI/City cite intervenor witnesses TerKeurst and Selwyn who pointed out that the Plan has a built in incentive for the Company to reclassify services as competitive and remove them from price cap limitations. AI has responded to this incentive by reclassifying services to competitive and adopting price *increases* unconstrained by market forces. Ms. TerKeurst testified that the reliance on competition to constrain rates removed from the Plan as competitive has proved to be misplaced, as in many significant cases, prices have been raised considerably upon reclassification. Therefore, the reliance on market forces to keep prices and earnings for competitive services reasonable has been misplaced.

Nothing in Section 13-506.1, GCI/ City claim, limits this Commission's review to Ameritech Illinois' noncompetitive rates. Rather, Section 13-506.1(b)(4) specifically requires as part of this review proceeding that the

Commission consider Section 13-103(a) which mandates that "telecommunications services should be available to all Illinois citizens at just, reasonable, and affordable rates..." 220 ILCS 5/13-103(a). According to the City, Ameritech has reclassified over half of its services as competitive under the Plan and given the ease with which reclassification has taken place and the absence of effective competition for reclassified services, AI has been able to raise the rates of many of these new "competitive" services immediately after reclassification.

GCI/City disagree with AI's assertion that the productivity offset "flowed through to consumers all of the productivity gains achieved by the Company during the 1995-99 period. They maintain that If the productivity offset had flowed all savings to consumers, one of two things would have happened: (1) AI's rates would have decreased consistent with the 11.06% X factor which Dr. Selwyn determined was the offset necessary to have maintained the Commission's 1994 rate of return, or (2) AI's 1999 test year data would not have shown earnings $276.1 of million (AI calculation), of $824.6 million (Staff calculation), or of $956 million (GCI calculation) greater than their current, reasonable cost of capital.

GCI/City believe that the most obvious and direct method to assess whether the price index mechanism has produced just and reasonable rates is to review AI's rates and earnings using rate of return principles. Using the accounting and cost of capital principles developed in rate of return analyses to determine what rate and revenue level is reasonable, and comparing it to the financial results of rate index mechanism, compares two separate and independent methods. According to the GCI/City, if rate of return regulation would produce rates between $276.1 million and $956 million lower than price index rates, it is clear that the rates produced by alternative regulation are unnecessarily high and are not fair, just and reasonable. GCI/City maintain that although earnings need not be precisely the same under each form of regulation, a disparity as large as that shown by the evidence in this docket requires a finding that the price index rates are not fair, just and reasonable.

Commission Analysis and Conclusion

Fair, just and reasonable rates is the standard set by law and the goal of all regulatory schemes. We confirm that this is the goal of alternative regulation as well as traditional rate of return regulation. Further, we find persuasive the argument that we should apply the existing legal definition of just and reasonable rates, and the requirement that shareholder and public interests be balanced in any ratemaking scheme. A key method to determine whether rates are fair, just and reasonable is by comparing earnings derived from price index rates against the earnings expected under rate of return regulation.

We conclude that we must review AI's earnings to determine if the interests of shareholders and the consuming public are fairly balanced. We adopt Staff's zone of reasonableness test, which was also accepted by GCI/City in their Exceptions, as consistent with state law and fair to all stakeholders. In Citizens Utility Board v. ICC, 276 Ill. App.3d 730, 736-737, 658 N.E.2d 1194, 1200 (1st Dist. 1995), the Court referred to extensive precedent for the proposition that fixing just and reasonable rates "involves a balancing of the investor and the consumer interests." Quoting Illinois Bell Telephone Co. v. Illinois Commerce Commission, 414 Ill. 275, 287, 111 N.E.2d 329 (1953), quoting Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603, 88 L.Ed. 333, 345, 64 S.Ct. 281, 288 (1944). The Court continued:

> The Commission has the responsibility of balancing the right of the utility's investors to a fair rate of return against the right of the public that it pay no more than the reasonable value of the utility's services. While the rates allowed can never be so low as to confiscatory, within this outer boundary, if the rightful expectations of the investors are not compatible with those of the consuming public, it is the latter which must prevail.

Quoting Camelot Utilities Inc. v. Illinois Commerce Commission, 51 Ill. App.3d 5, 10, 365 N.E.2d 312 (1977). We find that the principle that investors are entitled to a fair return on their investment and that the consuming public is entitled to rates that are no more than the reasonable value of the utility's services defines just and reasonable rates. Because the General Assembly did not redefine "just and reasonable rates" in section 13-506.1

where it authorized alternative regulation, as was done in other states, we conclude that the existing definition is legally mandated, and further, is appropriate. The symmetrical treatment of both robust earnings and under-earnings works in fairness to both the Company and the ratepayer.

Alternative regulation is an alternative regulatory mechanism to achieve the same regulatory goal as rate of return regulation, i.e. fair, just and reasonable rates. In this review proceeding, we find that the extraordinarily high returns reported under alternative regulation indicate that alternative regulation has not produced just and reasonable rates and a rate reduction is in order. Certainly if we were faced with earnings of this magnitude for a Company operating under rate of return regulation we would not hesitate to make the reductions necessary to insure just and reasonable rates and restore the balance of shareholder and ratepayer interests. Contrary to AI's argument, alternative regulation does not give the Company free rein to receive unlimited and unreviewable profit levels.

AI and Staff contend that the analysis of fair, just and reasonable rates under the Plan applies only to rates for non-competitive services. Although we agree that the price index mechanism only sets the prices for non-competitive services, we also note that the Plan was intended to harness the price constraining power of the market to set just and reasonable competitive rates. In this review proceeding we are cognizant of the fact that the prices for services classified as competitive have been increased more often than they have been decreased, and that significant Commission resources have been devoted to monitoring and litigating whether certain reclassifications were appropriate. We also consider the fact that under rate of return regulation, competitive services are included in any earnings or rate analysis.

We find that excluding competitive services from the just and reasonable analysis necessary under the Act would hamper our ability to assess whether there has been a proper balance between ratepayers and shareholders, and provide an incomplete and possibly distorted picture of whether the Plan has produced fair, just and reasonable rates five years after its enactment. It was our intention and assumption that market forces would constrain competitive rates so that AI's overall earnings would remain reasonable over the course of the Plan. Our review of total intrastate, jurisdictional operations, including competitive and non-competitive services, allows us to determine whether this assumption was correct.

AI argues that under alternative regulation earnings are not the primary focus because the price index assumes the place of general rate proceedings. We agree that during the Plan, AI is correct. We did not review the rates produced by the price index in the annual rate filings under the fair, just and reasonable standard. However, this proceeding is a review of the Plan, and a determination of whether it has met statutory requirements and Commission goals and expectations. If we focus simply on prices, or on whether the mechanics of the Plan were followed, as AI urges, we would be failing our responsibility to determine whether the Plan as a whole – including the effects on competitive and non-competitive rates and earnings – operated as we intended and ultimately whether it complied with section 13-506.1 requirements.

In this review of AI's performance under the Plan, the evidence shows that it earned more than the rate of return established in 1994. When adopting the Plan for AI, the Commission recognized the possibility of just such an outcome. Those earnings are the result of a number of variables, both within and outside the control of the Company. Nevertheless, the consistency and the extent of the high earnings convince us that the price index did not result in rates that accurately reflect cost or that were constrained by market forces. We conclude that returns that, by the Company's own account are 2 ½ times higher than the reasonable cost of capital, are beyond the zone of reasonableness, and that ratepayer and shareholder interests have not been fairly balanced under the Plan.

We conclude that in this review proceeding rates must be reset to fair, just and reasonable levels so that shareholder and ratepayer interests are fairly balanced. The extent to which rates are reset is determined by our resolution of the depreciation, cost of capital and accounting issues discussed later in this Order. We will also address the appropriate rate design to reflect the earnings reduction we order herein.

2. Has the Plan Reduced Regulatory Delay and Costs Over Time?

Authority: Section 13-506.1 (a) and Alt Reg Order.

In its 1994 Order, the Commission recognized that traditional rate of return regulation imposed significant costs on all parties involved, with exhaustive 11-month proceedings. The Commission found that price regulation, in contrast, would permit streamlined proceedings and would eliminate regulatory review of the "prudence of incurred costs, equipment replacement and cost of capital". (Alt Reg Order at 180-81).

AI's Position

AI takes the position that the Plan clearly met the requirements of the law and the Commission's expectations. According to the Company, the annual filing process has worked well. It has been very streamlined and rate changes go into effect in three months, and not the customary 11 months.

Staff's Position

According to Staff, here is little doubt but that the Plan has resulted in reduced regulatory delay and costs. This is especially so, Staff maintains, given that rate reductions thereunder have been automatic. (Staff Initial Brief at 32)

CGI/City's Positions

CUB contends that, as GCI witness Dr. Selwyn observed, the Plan has not met the objective of Section 13-506.1(a). To begin, CUB notes that the Alt Reg. proceeding took 22 months to complete. In addition, CUB notes that a 3-month proceeding occurs each year whereby noncompetitive rates are set. To this, CUB would add both the time expended on the SBC/Ameritech merger proceeding and the proceeding to challenge premature classification of services from noncompetitive to competitive. These proceedings, CUB argues, only occurred because AI was under price cap regulation and may well have been avoided had the Company remained under rate of return regulation. When considered cumulatively, CUB argues, these proceedings significantly surpass the amount of time that would be spent on three, 11-month rate cases and show that the AI price cap plan has *not* reduced regulatory delay and costs over time.

All GCI/City argue that in the place of one eleven month rate case, there have been 6 annual rate filings of 3 months each, totaling 18 months. Witnesses have been retained to review the annual filings, see GCI/City Ex. 3.0 at 2, parties have filed comments and reply comments, and the Commission has addressed numerous issues in those dockets including requests for exogenous treatment (ICC Docket 96-0172), the effect of changes to the GDPPI (ICC Docket 97-0157), and requests for merger savings (ICC Docket 00-0260). Although a rate case takes 11 months, rates can also be reduced by agreement in appropriate circumstances. Parties have also been involved in extended and fiercely contested proceedings concerning IBT's competitive reclassifications, which stem at least in part from the incentives alternative regulation provides to reclassify non-competitive services. See GCI Ex.1.0 at 27-28; GCI Ex. 1.5 (Staff Report about ICC Dockets 95-0135/95-0197 and 96-0069 and history related therein); ICC Docket 98-0860 (initiated after November, 1998 Staff Report, HEPO issued March 30, 2001). They point out that there has been no shortage of contested cases during the course of the alternative regulation plan.

AI Response

AI contends that it makes no sense to count against the Plan the 22 months which it took the Commission to adopt it in the first place given that this was a major and unexplored regulatory change warranting serious review. In AI's view, none of the usual active participants in telecommunications dockets (the Company, Staff or the Intervenors) could possibly have devoted more resources to the price cap filings than they would have to one or more general rate cases during this period.

AI disagrees with the argument that the cumulative amount of time required by the annual filings exceeds that of a general rate case. AI contests CUB's claims that the SBC/Ameritech merger and competitive, classification proceedings would not have occurred under rate of return regulation. According to AI, SBC made clear in the merger proceeding that the driving force behind the merger was the need to achieve the scale and scope of a global telecommunications company and thus, only financially punitive regulatory climates in all five Ameritech states (not just continued rate of return regulation in Illinois) would likely have changed SBC's decision.

AI further contends that competitive classifications actions have nothing to do with the Plan. It states that these reclassifications could and would have been made regardless of what form of regulation applied.

Commission Analysis and Conclusion

We find that the goal of alternative regulation to reduce costs and delays has been partly met. The standard is the reduction of delay and costs "over time." Although rate cases have been avoided, other proceedings have arisen, including the annual rate filings. Nevertheless, the annual filings produce an outcome for each year of the Plan without the intensity and effort required in rate cases. We conclude that the Plan has satisfied this requirement, although significant regulatory delays and costs remain.

3. Has the Plan Encouraged Innovation in Telecommunications Services?

Authority: Section 13-506.1(a)(1) and Alt Reg. Order.

In 1994, the Commission expected that the prospects of higher earnings would incent the Company to aggressively develop and offer new services; that the removal of prudency reviews would encourage the Company to be more innovative and take more risks; and that the ability to change prices without regulatory involvement would allow the Company to experiment more in the marketplace. (Alt Reg Order at 181.)

AI's Position

Ameritech Illinois contends that it has been more innovative with new services being an important factor in generating revenue growth. AI provides, as an example, its offering of "Privacy Manager" which allows customers to pre-screen their calls and eliminate telemarketing or other unwanted intrusions. Ameritech points out that it was the first RBOC in the nation to offer this service which is now widely imitated. The Company also claims to have experimented in the marketplace with a large number of promotional offerings and the introduction of optional calling plans. Today, AI contends, a substantial portion of its residential customers take service under one of these plans.

GCI/City's Position

GCI/City parties suggest that no more innovation occurred under the Plan than would have otherwise occurred under rate of return regulation. As pointed out by City witness Dr. Selwyn, basic telephone service in Illinois today is hardly different than that which existed in 1994. According to GCI/City, whatever "enhancements" or "innovations" in services have taken place are traceable primarily to equipment vendors rather than to specific AI initiatives. GCI/City argue that other than Privacy Manager and the discredited calling plans, IBT has identified no service innovations.

GCI/City further contends that despite the fact that the costs of individual telephone calls are virtually distance-insensitive, and the costs of network usage have declined dramatically over the past decade, AI continues to make unwarranted distinctions in name and price in local and toll calls. In addition, GCI/City claim, AI has actually increased its rates for certain local and intralata calls, particularly band C residence and business calls. Further, GCI/City note that although DSL technology has been around for a number of years, it is available in only a limited number of exchanges, and to only a limited number of subscribers within those exchanges to only a limited number of subscribers. CUB also notes that AI has chosen to suspend its "Project Pronto" deployment of DSL service. According to CUB, the Plan has *not* encouraged innovation in telecommunications services.

AI'S RESPONSE

In response to Dr. Selwyn's belief that the Company's usage rate structure should be less distance-sensitive, AI points out that this is a rate design judgment call, not a matter of "innovation". So too, AI notes, Dr. Selwyn's claim that Ameritech Illinois's roll-out of DSL has been too slow ignores the fact that this service is offered by Ameritech Illinois' affiliate AADS. The Company argues that, as in other instances, AADS' deployment record cannot be counted against Ameritech Illinois.

The complaint that most "innovations" can be traced to equipment vendors and not Ameritech Illinois does not make it a Company failing, AI maintains. Indeed, the point that vendors develop the switch hardware and software which enables new features and functionalities for the entire industry, was first set out in AI's own testimony. (See, Am. Ill. Ex. 1.1, p. 51). There, Mr. Gebhardt explained that the development of truly "new" services depends on the capabilities of the switching fabric itself, which has been the province of switch vendors. Short of becoming an equipment manufacturer, hardly a realistic alternative, AI maintains that its service introduction record is solid.

Commission Analysis and Conclusion

We find that the innovations which Ameritech has described are limited. Therefore, we do not find that the Plan has encouraged innovation beyond what would be expected in the absence of alternative regulation.

4. Did the Plan Respond to Changes In Technology And The Structure Of The Telecommunications Industry That Are, In Fact Occurring.

Authority: Section 13-506.1(b)(3) and Alt Reg. Order.

In its 1994 Order, the Commission found that the Plan met this objective because Ameritech Illinois' market environment would be increasingly competitive; that significant changes in technology were taking place; and that price regulation was better suited to these changes than rate of return regulation. (Alt Reg Order at 187-88.)

AI's Position

AI contends that the market environment has increasingly become more competitive with many more, as well as many more diverse, providers today than there were in 1994 and these competitors are successful in winning business from Ameritech Illinois. AI notes that in 1994, CLECs like MFS and TCG were just beginning to offer switched services to customers in Ameritech Illinois' service territory. Today, AI maintains, the Commission has certificated at least 59 CLECs, which collectively use a mix of resold services, UNEs and their own facilities to provide local exchange service. These CLECs, according to AI, include major IXCs like AT&T and MCI, fixed wireless competitors, cable companies and data CLECs. The scope of local competition has increased to the point, AI contends, where CLECs now have investments in place that can readily serve most of Ameritech Illinois' business and residential customers.

So too, AI maintains, there have been some significant changes in technology. An explosion in data traffic, driven in significant part by the Internet, is transforming the industry and requiring significant changes in Ameritech Illinois' network and network architecture. In 1994, AI contends, the Internet was just beginning to be used for commercial applications and voice communications constituted 87% of the revenue generated by the network. Today, however, evidence shows that business customers are restructuring their operations around the Internet and 45% of U.S. households have Internet access. AI explains that traffic on the network has fundamentally shifted from voice to data, and Internet transactions are substituting for voice transactions. Further, AI notes, wireless capacity has expanded rapidly and prices have declined, as customers increasingly substitute wireless for wireline calls.

As such, AI believes that the marketplace dynamics which drove the adoption of price regulation in 1994 are even more compelling today. Increased pressure from competitors using different, and more advanced, technologies than exist today in the Company's network will require appropriate responses for AI to keep competitive.

GCI/City's Position

The AG argues that the Act requires that an alternative regulation plan respond to changes that are "in fact, occurring." 220 ILCS 5/13-506.1(b)(3). The AG quoted the Commission's 1994 Order to show that the Commission believed that "the market environment which Illinois Bell will be facing in the future will be an increasingly competitive one. Price regulation responds to these changes in the structure of the telecommunications industry." Alt. Reg. Order at 187. The Commission expected "market forces [to] control competitive prices and earnings," and that "price regulation would protect ratepayers from revenue losses due to increased competition or increased costs due to management errors in responding to that competition." Id. The Commission concluded that its plan was based, not only on "where we are today, but where we will be, and where we want to be, tomorrow." Id. at 188.

The AG argues that alternative regulation was intended to provide a transition to a competitive market, but that the anticipated competition has not developed. IBT retains 95% of the local business and residential market, and this 5% is shared by 59 of IBT's competitors. It points out that as of September, 2000, 3.56% of lines are resold and 2.7% are provided on a UNE loop basis, demonstrating that IBT continues to receive revenues from these "competitors" and continues to be the price-setter for the industry.

The AG argues that the lack of competition has been of concern to the Commission. It points out that in its order addressing the reclassification of bands B and C calls and other operator services (ICC Docket 95-0135/0179), the Commission stated: "The evidence indicates ...that the declaration of competition in this case is being used as a device to raise rates to customers which demonstrably have not found the alternative offerings by other carriers to be the functional equivalents or reasonably available substitutes for Ameritech Illinois' service." In response to a subsequent competitive filing made by IBT, the Commission opened docket 98-0860. The Hearing Examiners have concluded that AI again reclassified services prematurely.

In response to AI's argument that competition has developed, GCI/City argue that the Commission has previously held, and the Court affirmed, the rejection of a competitive classification when IBT's market share was significantly lower at 86.6%. Illinois Bell Telephone Co. v. Illinois Commerce Commission, 282 Ill.App.3d 672 (1996). The Court stated:

> Based on the Act's declaration that competition should be allowed to function as a substitute for regulation only when consistent with the protection of consumers, 220 ILCS 5/13-103(b) (West 1994), it was reasonable for the Commission to conclude that the legislature intended to allow a provider to classify a service as competition only when competition had developed to the extent that regulation was no longer necessary. **Allowing a provider to classify a service as competitive prior to the development of a competitive market for the service would enable the provider to enjoy the benefits of a monopoly without the concomitant regulation which the legislature has declared in necessary to protect the interests of consumers.** Accordingly, the Commission'[s conclusion that it must examine actual market behavior in order to determine whether a competing service is reasonably available was not clearly erroneous and we defer to this interpretation.

282 Ill.App.3d at 677 (emphasis added).

The AG questions whether the plan appropriately responded to changes in the telecommunications market that are, "in fact, occurring", as required by 220 ILCS 5/13-506.1(b)(3) given the extent of the competitive reclassifications since the adoption of the alternative regulation plan, the repeated price increases, and the extraordinarily high returns reported by IBT. It asserts that the plan allows IBT to flow profits to shareholders without the check of rate of return regulation, so increased revenues from services classified as competitive are retained by the company without the earnings review inherent in rate of return regulation. These effects, combined with the PUA's provisions allowing reclassification of services and price increases on one day notice, "set the stage for Ameritech Illinois price increases for services prematurely classified as competitive, unchecked by competitive forces offering lower-priced alternatives to customers." GCI Ex. 1.0 at 26.

In response to AI witness Gebhardt's testimony that the Company's digital network as evidence that the plan has delivered technological advancements to AI's customer base, CUB points out that the Company's testimony in the original Alt Reg Order Docket showed that AI would have only 18 analog switches (the precursor technology to digital switching) remaining at the end of 1994. (See Alt Reg. Order at 150.) With or without price regulation, the Company anticipated that it would complete the analog switch replacement work by the end of 1997. Hence, CUB argues, the Company's delivery of its end-to-end digital network is not evidence of, or attributable to, any alternative regulation success.

Even if it is true that the Company, as AI witness Gebhardt testified, has spent millions of dollars opening its networks to competitors, CUB claims that this has not been enough to alter in any meaningful way the competitive nature of the local exchange marketplace, particularly for residential customers. In any event, CUB argues, the additional investment made by AI to spur competitive growth has been more a function of Commission decisions and federal law, than alternative regulation. As such, CUB relies on Dr. Selwyn's observation that AI's testimony is absent any evidence showing that it addressed changes in technology any differently under the price cap plan than it would have under rate-of-return regulation.

AI Response

AI argues that CUB and the AG misperceive the Commission's expectations for the Plan by contending that the Plan was not responsive because the residential local service marketplace is not yet fully competitive. According to AI, the Commission adopted price regulation because it would adapt to marketplace changes over the long run -- not just for the next five years. To be sure, AI contends, the Commission imposed a five-year rate cap on residential services because it assumed that residential local service would <u>not</u> become fully competitive and would <u>not</u> become subject to marketplace pricing constraints during this period. AI notes that the Commission specifically stated that this rate cap would allow it to "grapple with the complex social and economic issues associated with new technologies and <u>emerging competition</u>" during this period. (See, <u>1994 Order</u> at 65 (emphasis added).

More to the point, AI claims, CUB and the Attorney General flatly ignore the risks associated with technological change and the Commission's concern that ratepayers be protected from those risks. (See, Alt Reg Order at 87-88.) The record shows, AI maintains, that technology is changing at a rapid rate and that, over the long run, the Plan will better protect customers from the financial consequences of that change than rate of return regulation.

Commission Analysis and Conclusion

When we adopted alternative regulation in 1994, we expected competition to develop much more quickly than it has developed. The lack of competition is a major Commission concern, and the evidence in this docket does not alleviate our concerns.

The failure of competition to develop during the course of the Plan, a period of more than six years, during which new wireless technology arose, the internet explosion occurred, and the Telecommunications Act of 1996 was adopted, undermines our confidence that the Plan was based on changes that actually occurred in the market-place. Our premature reliance on the development of competition has led to excessive, unconstrained prices for services reclassified as competitive, and the lack of an earnings cap or review has eliminated any regulatory constraint on prices for competitive services.

We conclude that the lack of meaningful competition is an additional factor that supports our decision to review AI's earnings to determine whether the Plan has resulted in fair, just and reasonable rates.

5. Has the Plan Produced Efficiency Gains and Cost Savings

Authority: Sections 13-506.1(b)(5); 13-506.1(a)(3) and Alt Reg Order.

The law requires findings that the Plan will promote efficiency and that ratepayers will benefit from any efficiency gains, cost savings and productivity improvements arising out of the regulatory change. In 1994, the Commission concluded that the Plan would provide Ameritech Illinois with incentives to implement cost saving efficiencies and new services, because of the potential for higher earnings if the Company were successful. The Commission further determined that ratepayers would benefit from these efficiencies and new services through the X factor, which would apply regardless whether the expected productivity gains were achieved. (Alt Reg Order at 188-89.)

AI's Position

AI maintains that the Plan did provide it with new incentives to become more efficient. It not only maintained, but increased, its productivity over the term of the Plan, and improved its performance on standard measures of efficiency in the industry. Moreover, AI asserts that the X factor was higher than Ameritech Illinois' total productivity gains such that consumers reaped all of the gains which Ameritech Illinois achieved, as well as some that it did not, which more than satisfies the statutory standard. Further, AI insists that its efficiency gains were not achieved at the expense of service quality. If kept in a proper perspective, AI maintains that its service quality was generally excellent during the 1994-99 period.

GCI/City's Position

CUB notes Dr. Selwyn's observation that any efficiency gains and cost savings arising out of the regulatory change, to the extent they exist, can only benefit AI ratepayers if they are passed on to them. CUB claims that because overall annual rate reductions triggered by the price cap formula have been accompanied by increases in rates reclassified as competitive, or bundled as new services, and left outside of the pricing constraints of the plan, - any alleged efficiency gains or cost savings have not benefitted AI's captive business and residential customers.

GCI/City further dispute the suggestion that consumers benefited from efficiency gains, and AI's position that the price index mechanism resulted in rate reductions that exceeded AI's productivity. According to GCI, if the rate reductions required by the price index exceeded AI's cost savings and productivity gains, one would expect its return on rate base and its return on equity to be lower than it was at the inception of the plan. This has not happened, GCI/City maintain, and AI has retained the vast majority of the benefits from its productivity and efficiency gains, sharing only the amount required by the price index irrespective of its actual cost savings.

In short, the GCI/City maintain that the Company has not identified how ratepayers benefitted from efficiency gains, cost savings arising out of the regulatory change, and improvements in productivity due to technological change, as required by section 13-506.1(b)(5).benefit from increased efficiency gains and cost savings.

AI's Response

Arguments whereby GCI/City contend that ratepayers did not appropriately benefit from the efficiency gains and cost savings which resulted from the Plan rest on a commingled view of noncompetitive and competitive service rate changes and earnings which AI views as improper. According to AI, the Plan's performance has to be assessed in terms of the services to which it applied. It is undisputed on record, AI contends, that the X factor flowed through to customers of Ameritech Illinois' noncompetitive services all of the productivity gains which the Company achieved.

Commission Analysis and Conclusion

The Commission relied on the X factor in the formula to ensure that efficiency gains and cost savings benefitted customers. Because AI's earnings grew substantially despite the annual rate reductions required by the Plan, we are concerned that the X factor was not adequate to capture a reasonable portion of AI's efficiency and productivity savings. This mismatch of the productivity offset and AI's earnings is an additional factor that supports our decision to review AI's earnings to determine whether the Plan has resulted in fair, just and reasonable rates.

6. Has the Plan Served to Prejudice Or Disadvantage Any Particular Customer Class?

Authority: Sections 13-506.1(b)(7); 13-103(d) and Alt Reg Order.

Under Section 13-506.1(b)(7), an alternative plan of regulation must not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunications carriers. In addition, the Commission must consider whether the Plan would result in discrimination or cross-subsidies under Section 13-103(d). In its 1994 Order, the Commission concluded that the basket structure would ensure that all customer classes would be treated equitably. The Commission also determined that the pricing flexibility limitations; that the residential price cap would protect residential customers; and that carriers were further protected by the requirement that intrastate carrier access rates could not exceed interstate carrier access rates. (Alt Reg Order at 190-91). With respect to discrimination and cross-subsidies, the Commission relied on the reasonableness of the Company's going-in rates, as well as the Imputation and Aggregate Revenue Tests. (Id. at 185).

AI's Position

AI maintains that that the basket structure and residential rate protections functioned precisely as the Commission intended because: (a) all of the rate reductions required by the Plan were flowed through equitably to each customer group; (b) the limits on pricing flexibility, combined with the low rate of inflation over this period and the residence rate cap, more than protected consumers of noncompetitive services from any rate increases and those rates declined; (c) there were no rate-related complaints of any significance over the Plan's initial term; and (d) all of the statutory service cost and pricing rules continued in effect and the Company has complied with them.

GCI/City's Position

The GCI/City agree with AI that the basket structure and pricing flexibility limitations were intended to protect consumers from undue or unreasonable disadvantage under the plan. They dispute, however, AI's position that the basket structure and residential rate protections functioned precisely as the Commission intended.

CI/City maintain that AI avoided some of these consumer protections by reclassifying services as competitive, even in the absence of competition, and removing them from the price cap plan protections. They add that AI repackaged basic, non-competitive residential services at different and often higher prices (e.g. Simplifive and CallPack rates, GCI Ex. 1.0 at 66; GCI Ex. 8.0 at 23-24) and categorized them as new services, again to avoid the pricing constraints of the price index. because new services are not subject to the index when initially offered, and after one year, are brought into the plan at the new, repackaged rate, even if it is higher than the price cap would have allowed for the underlying, non-competitive service. They assert that AI also skirted the basket structure and undermined its intention to make benefits available to all classes of consumers by placing "new services" in the "other" basket, even when the underlying service is identical to the services contained in the residential basket, i.e. access and usage for bands A and B. Staff pointed out in its Initial Brief that calling plans account for over 90% of AI's revenues from new services. These revenues, the GCI/City contend, are from services that should have been included in the residential basket, and subject to the same pricing limitation applicable to other residential basket services.

The AG asserted that despite years of declining costs and increasing profits, IBT has not reduced the residential network access line and has concentrated the reductions in the residential basket (access and bands A and B) in volume discounts. Therefore, the customers who "benefit" from alternative regulation are those that make the most use of IBT's system. The AG maintains that consumers who simply subscribe to basic service have seen fewer benefits than the Commission intended due to IBT's premature reclassification of services as competitive, abuse of the new services provision of the plan, removal of a portion of residential bands A and B usage service to the "other" basket, and failure to reduce residential NAL during the course of the plan despite substantial, company-wide cost savings.

AI's Response

In response to the AG's assertion that Ameritech Illinois' rate design decisions in the residence basket have consisted of usage volume discounts, and have been primarily benefitted customers who make use of the Company's network, AI notes that the AG would have preferred reductions in network access lines, which are subscribed to by customers who make little or no use of the network. This, AI maintains, does not constitute "prejudice" or "disadvantage". The Company made clear in 1994 that it believed residential network access lines were underpriced and that it had no intention of reducing those rates under the Plan. (See, Alt Reg Order at 63, 68). It claims that its rate rebalancing proposal shows that circumstances have not changed.

The Company's consistent pricing policy over the last seven years relative to this issue has not been "prejudicial" within the meaning of the statute. In AI's view, it is not unreasonable for rate reductions to flow more heavily in the direction of customers who actually make use of its network, as compared to customers who do not. Such a result, AI contends, increases overall consumer welfare.

Commission Analysis and Conclusions

Section 13-506.1(b)(7) requires that the Plan "will not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunication carriers." The question before us is whether the basket structure and pricing limits protected all customer classes, or resulted in undue or unreasonable prejudice or disadvantage. We note that the statute does not address "discrimination", which is a concept which calls for a comparison.

Based on the evidence, and Staff's and GCI/City's account of AI's use of the new services provisions of the Plan, the Commission believes that the service baskets which we structured have not operated as expected. Hence, we find that this requirement has not been fully satisfied, and that changes to the basket structure need to be made going forward.

7. Whether There Has Been Broad Dissemination of Technical Improvements and Economic Development

Authority: Sections 13 - 506.1(a)(4); 13-506.1(a)(5); 13-103(f) and Alt Reg Order:

Sections 13-506.1(a)(4), 13-506.1(a)(5) and 13-103(f) require the Commission to consider whether alternative regulation plans will facilitate the broad dissemination of technical improvements to all classes of ratepayers and enhance the economic development of the State. In its 1994 Order, the Commission concluded that price regulation provided the appropriate incentives to encourage market-based investment in infrastructure; that the Company had made a $3 billion commitment to grow and modernize its network; and that, because most of Ameritech Illinois' plant-in-service is used to provide service jointly to all customer classes, all classes of customers would benefit from this investment. (Alt Reg Order at 182, 183). The Commission also determined, based on economic analyses presented in that proceeding, that there was a generally positive relationship between network modernization and economic development.

AI's Position

Ameritech Illinois contends that it not only met, but exceeded, its $3 billion commitment by spending $3.7 billion. Those investments AI contends, facilitated the development of an advanced telecommunications infrastructure. Today, AI maintains all of Ameritech Illinois' customers have digital switching capabilities available to them. So too, virtually all of the Company's interoffice facilities are now fiber. Further, over 90% of the Company's access lines have access to ISDN. In addition, SS7 deployment is complete and 65% of the Company's central offices have been equipped with the AIN platform. All of these technologies, AI claims, are important building blocks for advanced services.

Ameritech Illinois notes that it also spent millions of dollars opening its networks to competitors. It contends that customers benefit from the expanded choice of alternative service providers. It notes further that the positive relationship between price regulation and network modernization which the Commission relied on in 1994 has now been further validated by a NARUC/NRRI study based on empirical data from jurisdictions throughout the United States. (Am. Ill. Ex. 4.2, at 3-4). Accordingly, AI asserts, the Commission can conclude that the Plan has enhanced economic development in the State.

GCI/City's Position

According to GCI/City, the Company presented no evidence to show that any technical improvements realized since 1994 would not have been achieved and spread over all customer classes if it had been operating under rate of return regulation. As pointed out by Dr. Selwyn, GCI/City claim that the $3.7 billion that AI invested over the term of the plan was not "new" investment, but was largely funded by ongoing depreciation charges and thereby represents the replacement of existing, "worn out" equipment rather than an infusion of new capital. Because it recorded a total of $3.4 billion in intrastate depreciation accruals over the 1995–1999 time period, AI actually made only $300 million in net investment according to GCI/City.

In any event, GCI/City claim, the $3.7 billion in investment claimed by the Company has not been sufficient to maintain basic service quality where AI did not target sufficient amounts into its basic local network, particularly to its outside plant, to ensure timely availability of network access – in new housing areas with high growth rates. Executives at SBC, (AI's corporate parent), conceded that point to the investment community by blaming service quality failures on Ameritech's "lack of maintenance and capacity in the outside plant." (See, GCI Ex. 2.0 at 68-69). Neither AI witnesses Jacobs or Gebhardt made mention of growth in the number of network access lines available to end users and, in addition, AI has chosen to suspend its "Project Pronto" deployment with respect to DSL service.

GCI/City further claim that the Company failed to provide a single example of economic development in this State that was a direct result of the AI price cap plan. The Company's assessment of its meeting the $3 billion commitment is suspect, GCI/City maintain, given that the majority of the investment represents replacement of worn equipment that, absent any evidence to the contrary, would have occurred under rate of return regulation. Thus, according to GCI/City, the Commission cannot assume that the plan has enhanced economic development simply because AI fulfilled its $3 billion investment commitment.

GCI/City further point out that the Plan gave IBT considerable freedom to invest in technology and infrastructure, with only the total, five year amount set by the plan (at $3 billion). However, it maintains that IBT has failed to adequately maintain its network so that access lines are available when needed, and repairs can be made expeditiously. Further, the AG asserts that AI has used pair gain technology to the detriment of consumers, so that IBT's customers may not be able to rely on the standard 56.6 kilobit data transmission speeds that have become the industry norm, but have been relegated to 14.4 kilobit transmission speed. The AG argues that it is inappropriate for IBT to maintaining that consumers who want transmission speeds faster than 14.4 kb can subscribe to the much higher priced, unregulated DSL service, allowing IBT's unregulated DSL service provider to reap the benefits from the degradation of noncompetitive service. The AG argues that this degradation of service is exactly the opposite of what the Commission intended as a result of alternative regulation.

In GCI/City's view, the record evidence belies AI's claim that the plan has successfully facilitated any broad dissemination of technical improvements to all classes of ratepayers.

AI's Response

AI takes issue with the GCI/City assertions as to the inadequacy of upgrades to its network. The record demonstrates, AI contends, that it has invested in the technology required to bring advanced services to this state. AI maintains that the claim that pair gain technology (digital loop carrier systems) disadvantages customers is incorrect, noting that this technology has been widely used by local exchange companies since the 1980's and provides the most cost effective means of provisioning a high quality outside plant network. AI further observes that the demand for high-speed Internet access is a relatively recent phenomenon which customers can obtain from any of the many alternative providers.

Commission Analysis and Conclusion

In 1994, the Commission predicted that there was a generally positive relationship between price regulation and network modernization, and between network modernization and economic development. However, we have not been shown that AI's investment in Illinois has been much more than was required by our 1994 Order, and did not significantly exceed its depreciation expense. We are further concerned that the investment made have not provided quality service to AI's retail or wholesale customers. Poor quality service does not enhance economic development and shows a lack of sufficient investment in plan and technology. We conclude that there has not been an increased or sufficient dissemination of new technology during the Plan

The Commission further observes that economic development depends on the availability of telecommunications service of sufficient quality and quantity offered by a variety of carriers. This requires that wholesale service quality be maintained and that sufficient investment be made to provide this service. We have been disappointed with AI's performance in this regard.

8. Competition

Authority: Sections 13-103(b) and Alt Reg Order.

Under Section 13-103(b), the Commission must consider whether the alternative regulation plan will promote the legislative goal of allowing competition to substitute for certain aspects of regulation, where consistent with the protection of consumers. In its 1994 Order, the Commission concluded that the Plan would further this goal, because price regulation better reflects the operating freedoms and constraints faced by competitive companies and reduces the economic burden of regulation generally. (Alt Reg Order at 184).

AI's Position

AI explains that price regulation is fundamentally a <u>retail</u> plan which governs the pricing of Ameritech Illinois' noncompetitive services to consumers and it establishes the governance structure relative to retail service quality, network investment and financial performance. It is not a <u>wholesale</u> plan. According to AI, price regulation plans do not, of themselves, either encourage or discourage the development of competition, except to the extent that they produce more efficient price signals to potential competitors. Indeed, AI notes, the original pioneering work on the merits of price regulation assumed a monopoly environment whereas now economists and regulators have concluded that price regulation is better adapted (than rate of return regulation) to the transition from monopolies to competition. In other words, AI claims, it makes no more sense to expect price regulation to promote competition than for rate of return regulation to do the same. In any event, AI maintains, it is uncontroverted that there is more competition today than there was in 1994.

Staff's Position

Staff notes that the transition to competition has not, in fact, taken place nearly as quickly as the Commission apparently believed, and presumably hoped that it would. It contends, however, that this factor be given "limited consideration at most." (Staff Initial Brief at 31).

GCI/City's Position

GCI/City maintain that one of the premises of the Plan was that competition would arise to replace the constrain of regulation. They quote the Alt. Reg. Order, to show that the Commission expected "market forces [to] control competitive prices and earnings," and that "price regulation would protect ratepayers from revenue losses due to increased competition or increased costs due to management errors in responding to that competition." Alt. Reg. Order at 187. They assert that the Commission clearly expected competition to to substitute for certain aspects of regulation, and that there would be sufficient competition to provide adequate consumer protection. Further, they rely on their arguments in connection with whether the Plan has responded appropriately to changes that in fact have occured in the telecommunications market to demonstrate that competition has not in fact arisen to constrain prices, affect service quality, or challenge AI's predominance in the marketplace. They add that competition in the residential market has been inconsequential, and note that the record evidence showing 6% market penetration combines both residential and business customers.

GCI/City also contend that the Plan has not promoted competition, which is one of the State's major policy goals. They claims that the level of competition in the local exchange services market is extremely limited such that the vast majority of residential customers and a substantial number of business customers still lack meaningful competitive options. The combination of the Plan's incentives to reclassify services as competitive to avoid the price index, the lack of an earnings cap or review, and the ineffectiveness of service quality protections have acted to hinder the growth of competition. Without adequate competition, GCI/City assert that the Commission cannot allow competition to substitute for certain aspects of regulation because the present situation does not meet the section 13-103(b) requirement that competition substitute for regulation only if it is consistent with the protection of consumers.

Commission Analysis and Conclusion

Although we agree with AI that the Plan was not designed to further or promote competition, we note that we expected competition to develop more quickly and more extensively than it has. Indeed, the Plan was based on the express expectation that competition would arise to the level that the marketplace would constrain prices and threaten AI's monopoly power. We have stated elsewhere that the slow development of competition has been a matter of great concern to the Commission, and we reiterate that concern here.

The question here, however, is whether competition has developed to such a point that it can be substituted for regulation to provide consumer protection against monopoly power. We are convinced that the slow pace of competitive entry, the extraordinary returns received by the Company during much of the Plan and continuing through the latest annual rate filing (see ICC Docket 01-0302 and IBT Annual Report required by 1994 Alt. Reg. Order), and the deterioration of service quality over the life of the Plan all demonstrate that the market is not developed enough to protect consumers and substitute for regulation. This conclusion is consistent with our conclusion in section III.4. above, and further supports our decision to adjust AI's rates so that its earnings are more in line with the reasonable, market-based, cost of capital.

9. Service Quality

Authority; Sections 13- 506.1(b)(6); 13-103(c) and Alt Reg Order.

Under Section 13-506.1(b)(6), the Commission must find that an alternative plan of regulation will "maintain" the quality and availability of telecommunications services offered by the applicant carrier. The Commission must also consider whether the plan will disrupt the telecommunications system or consumer services under Section 13-103(c). In its 1994 Order, the Commission found that the then current quality of service provided by Ameritech Illinois was "fully satisfactory". The Commission concluded that the service quality component of the price index, which included penalties, would provide Ameritech Illinois with incentives to maintain service quality. The Commission also concluded that the incentives to invest in its network and the pricing restrictions in the Plan would ensure the availability of services to consumers. Finally, the Commission concluded that nothing in the Plan would change the way Ameritech Illinois delivered service to its customers. (Alt Reg Order at 184, 189-90.)

AI's Position

On the whole, AI contends, service quality improved significantly over the first five-year term of the Plan—the principal exception being the measure for out of service over 24 hours ("OOS>24"). During that term of the Plan, AI notes that its performance <u>improved</u> for seven of the eight current benchmarks.

AI observes that Staff witness McClerren focused on so-called monthly "misses" in his direct testimony. Aside from OOS>24, however, monthly data confirm that Ameritech Illinois' performance has improved steadily under the Plan. For the other seven (7) measures, AI claims its performance exceeded the benchmarks for 399 of 420 monthly data points (95%). The number of monthly "misses" fell steadily between 1994 (17 misses) and 1999 (four misses). Considering that those benchmarks were based on annual, not monthly, performance during 1990-91 AI claims, that is a remarkable record.

In his rebuttal testimony, Mr. McClerren suggested comparing the average level of performance prior to the adoption of the Plan (using data for the periods 1990-94 and 1990-91) to performance since the Plan was adopted (1995-2000). Those comparisons, AI confirms, confirm that performance has improved substantially, again with the single exception of OOS>24.

AI notes that Staff and GCI continue to focus primarily -- indeed almost exclusively--on two service quality issues: (a) performance for the measure Out of Service Over 24 Hours ("OOS>24") and (b) the more generalized installation and repair problems during the second half of 2000. Ameritech Illinois does not dispute its failures regarding those issues, nor has it minimized the seriousness of those failures. It would, however, direct the Commission to consider on this review whether the Plan on the whole succeeded in maintaining service quality. If service quality performance is considered for all measures over the entire period of the Plan, AI maintains, it is clear that the Plan's successes outnumber its failures by a large margin. This is true, AI contends, even if one measures the success of the Plan precisely in the ways that Staff and the GCI allege that the Plan should be judged.

Staff witness McClerren testified that the success of the Plan should be measured, at least with respect to the measures in the current Plan, by comparing performance before and after the Plan was adopted. He compared the years 1995-2000 to the years 1990-91 and 1990-94 respectively, but only performed this analysis for OOS>24.

The results for the other seven measures, AI contends, all show steady improvement over the initial term of the Plan. Indeed, AI claims, many of the most important measures of service quality improved by large margins. For example, Trouble Reports per 100 Access Lines, - the best overall measure of network performance in AI's view - improved by more than 30% from 1990-94 to 1995-2000. So too, AI argues, the other measures improved over that period by margins ranging from roughly 20% to 100%. Considered on the basis of Staff's approach, AI contends, most measures of service quality have improved markedly.

GCI witness TerKeurst testified that, to get a more complete picture, one must also consider measures of service quality other than those included in the Plan. She, did not actually perform that analysis, AI claims, on the grounds that no pre-Plan data were available for measures outside the Plan. On the basis of data submitted by CUB (in its 1996 service quality complaint case), AI notes, the comparison which Ms. TerKeurst suggests to show that service quality has not declined, but instead improved since the Plan was adopted. Data gathered since the adoption of the Plan are either consistent with, or better, than pre-Plan data for all such measures for which data are available: Business Office Answering Time, Repair Office Answering Time, Repeat Trouble Rate (Installation), Repeat Trouble Rate (Repair), and Missed Repair Appointments. Thus, AI maintains, service quality also improved based on the approach suggested by Ms. TerKeurst.

As for OOS>24, Ameritech Illinois does not deny it has struggled to comply the Commission's five-percent standard which it notes to be a very demanding benchmark. Nevertheless, Ameritech Illinois recognizes its responsibility to comply with this measure and is committed to meeting it. Its commitment, AI claims, is reflected in the sharp drop in OOS>24 cases, - from an average of 14.1% in 1995-97 to an average of 7.9% in 1998-99 - approximately the same level at which the Company was performing before the Plan was adopted. With the increases in network staffing and spending, Ameritech Illinois believes it is on track to comply consistently with this benchmark, as its recent performance shows. (AI requests that administrative notice be taken of its recent performance data, but it has not proceeded as required under the Commission's Rules of Practice.

With respect to the installation and repair delays that occurred in the second half of 2000, Mr. Hudzik testified that such problems were the result of retirements by an unexpectedly large number of network employees in 1999, coupled with rising workloads and inclement weather.

While certain of the parties suggest that a lack of network facilities also contributed to the installation and repair problems in 2000, AI notes that the record contains little, if any, evidence that the network itself is deficient. Indeed, Performance for Trouble Reports per 100 Access Lines, - the most important measure of network performance in AI's view - improved significantly under the Plan, (from an average of 2.92 for 1990-94 to an average of 2.02 for 1995-2000). In year 2000, AI notes, only 1.81 access lines per 100 were out of service. Dial Tone Within Three Seconds and Trunk Groups Below Objective - which also measure network performance -

improved to a point that problems are virtually extinct, such that Staff now proposes to eliminate both of those measures.

Furthermore, AI contends, its installation and repair performance has improved rapidly as with new hirings. Such improvement, AI contends, would not have been possible if adequate facilities were not available. AI maintains that all of this evidence shows that headcount losses and not inadequate network facilities, led to the installation and repair delays which occurred in the second half of 2000. Mr. Whitacre's comments, quoted by the GCI, are not to the contrary, AI claims, as Mr. Hudzik explained:

> "[T]o the extent that additional infrastructure investments could have offset the impact caused by the loss of much of our workforce, it might have mitigated some of the service problems experienced in 2000. However, the more immediate problem was the effect of construction forces that typically are devoted to infrastructure improvements and expansion to address the daily repair and installation loads, which were building due to loss of many of our technicians. I see nothing in Mr. Whitacre's statements that would be to the contrary. In fact, Mr. Whitacre specifically noted that the problem was being addressed by hiring additional technicians." (Am. Ill. Ex. 12.1, p. 12).

AI observes that while Cook County appears to agree that headcount was the problem, it would attribute the loss of headcount to post-merger cost cuts with early retirement packages and other incentives to retire some of its most experienced managers and technicians prior to the 'unanticipated' exodus that led to the service problems in the second half of 2000. AI maintains that these allegations are absolutely wrong because it offered <u>no</u> enhanced retirement benefits to either management or non-management network employees before the headcount losses occurred. According to AI, Cook County's allegations to the contrary have no basis in the record.

As AI's witness Hudzik explained, an unexpectedly high number of network employees retired in 1999 despite the fact that Ameritech Illinois' had proactively implemented measures which offset the impact of GATT-related changes for all network employees, both management and non-management, that would potentially be affected. Far from being an incentive to retire, as Mr. Hudzik explained, "the purpose of it was to get employees to change their minds and not retire." (Tr. 1953).

Ameritech Illinois maintains that it acted early and aggressively to maintain its network headcount. It renegotiated its collective bargaining agreements and offered additional benefits to non-management employees to avoid GATT-related headcount losses. Those changes were effective January 1, 1999. By mid-1999, when attrition proved greater than expected, Ameritech Illinois identified the problem and began hiring immediately.

By January 2000, long before service quality problems began, headcount was rising. And, in early 2000, still before service quality problems became apparent, Ameritech Illinois accelerated its hiring program. By the beginning of 2001, Ameritech Illinois had added 1468 network employees (over 17%), far more than restoring the 10% headcount loss that had occurred in 1999. AI notes that forecasts call for the Company to add another 900 network employees by the end of 2001. (Tr. 1958).

According to AI, the headcount increases have been accompanied by an enormous increase in network spending. Its network capital investments in Illinois have grown from $787 million in 1999, to $918 in 2000, to $1.043 million (estimated budget) for 2001. And, expenses have risen from $495 million in 1999, to $664 million in 2000, to nearly $800 million (estimated budget excluding network planning and engineering) in 2001.

AI claims that its performance has responded accordingly, since the second half of 2000, the average interval for installations requiring field visits fell, from 14 days to 5 days. Pending installation orders, requiring field visits, dropped from 48,506 to 22,411. In addition, OOS>24 was reduced to 4.3%, the average interval for all repairs fell from 54 hours to 21 hours, and the pending repair load shrunk from 19,501 cases to 9,323. In this same time period, customer complaints fell dramatically.

Certain of the GCI parties contend that business and repair office answering performance has also been deficient. But, AI maintains, there is little evidence to support this claim. It notes that, business and repair office answer times are "new" Part 730 standards in Illinois, made effective in October 2000. As a result, answer time data are limited, and the data available prior to October do not consistently measure performance for the same calling centers. While the GCI parties have characterized answer times as excessive, AI maintains that there is no evidence that actual consumers share that view. AI notes that, Staff's review of customer complaints did not identify answer times as a problem. Similarly, customer survey data for February through August 2000 showed that customers rated the ease of getting their calls through to Ameritech Illinois' business and repair offices in the neutral to satisfied range--from 64.6 to 75.3, where 54 is neutral and 84 is satisfied.

In any event, in response to the Commission's new rules, Ameritech Illinois has hired additional employees in its business and repair offices. This, it claims, will assure staffing sufficient to comply with the 60-second answer time requirement in the Commission's Part 730 rules. Here too AI claims, its recent performance reflects its additional hiring (and spending). As of the first of the year, business and repair office answering times averaged 60 and 31 seconds, respectively, for all calling centers.

AI notes that certain of the GCI parties i.e., CUB and the Attorney General contend that Ameritech Illinois "currently" queues customers from other states ahead of Illinois customers on calls to collection centers. Those claims are wrong, and Mr. Hudzik specifically explained, the queuing process described by the GCI was limited to a single call center for a short period of time prior to the effective date of the Commission's answer time standards. No such queuing of customers, AI maintains, has occurred since October 2000.

GCI/City's Position

GCI and City contend that the Company's performance, in key service quality areas, has been abysmal. The record, CUB claims, demonstrates a decline in Ameritech Illinois' service quality since the inception of alternative regulation and, more dramatically, since the Ameritech/SBC merger. CUB highlights the decline in AI's service quality as follows:

- Ameritech Illinois' performance in restoring service to customers within 24 hours of a reported outage (i.e., the OOS>24 measure) has declined dramatically. Its rate of failure in correcting "out of service" situations within 24 hours averaged about 14.1 percent between 1995 and 1998—over twice the average rate of failure in 1990 through 1994. While Ameritech Illinois reported some progress in 1999, its OOS>24 performance declined again in 2000, reaching 15.2 percent in August 2000. For the month of September 2000, AI reported an OOS>24 rate of 37%, more than seven times the allowed rate per 83 Ill. Admin. Code Part 730 and the existing plan.

- The number of lines that were "out of service" almost doubled between late 1999 and mid-2000.

- Since early 1999, the average number of days needed to install a new access line Plain Old Telephone Service ("POTS") (the POTS Mean Installation Interval measure)) has more than doubled for residential customers.

- Between December 1999 and June 2000, the speed at which customer calls are answered (the Average Speed of Answer measure) declined in the residential and repair call centers and the percent of customer calls answered in those call centers (as captured by the % Calls Answered measure) also declined.

- The average time to repair service, whether for all telecommunications service troubles as a whole (the Mean Time to Repair measure) or for POTS trouble on a stand-alone basis (the POTS Mean Time to Repair measure) has sharply increased since the SBC/Ameritech merger, with Ameritech Illinois reporting 77.7 hours to repair POTS in September 2000.

- Ameritech Illinois failed to keep an increasing percent of its POTS repair appointments (the POTS Missed Repair Appointments—Company Reasons measure) since 1998, missing 15.5% of its repair appointments in September 2000.

- Between 1999 and 2000, repair complaints increased by 71 percent, installation complaints increased by 190 percent, and construction and engineering complaints increased by 119 percent.

- By August 2000, the number of consumer complaints to Ameritech Illinois as tabulated through the executive appeals complaints process increased compared to 1999. Consumer complaint levels increased by 28 percent, 51 percent, 56 percent and 92 percent for maintenance, network, construction, and customer provisioning complaints, respectively.

- The percent of customers assigning Ameritech Illinois a low score of 0 to 5 (out of 10 points) for service quality in AI customer surveys increased by 20 percent from January 1999 to August 2000.

- Variations in state requirements have resulted in discriminatory treatment of Ameritech Illinois customers. Specifically, calls to Ameritech/SBC's collection offices by customers in other states are currently routed ahead of Illinois customer calls to meet other states' service quality standards.

- Ameritech Illinois' performance in answering calls from residential customers declined significantly between 1997 (the earliest year for which data is available) and mid-1999. The average speed at which Ameritech Illinois answers residential customer calls (the Average Speed of Answer—Residential Customer Call Centers measure) increased from 38.2 seconds in January 1997 to 413.1 seconds in June 1999. The percent of residential customer calls answered (the % Calls Answered—Residential Customer Call Centers measure) declined dramatically, from 93.2 percent in January 1997 to 59.5 percent in June 1999.

According to GCI, further indication of the decline in AI's service quality performance under the plan is found in the records of the ICC's Consumer Services Division ("CSD"), as discussed by Staff witness Jackson. In 1995, the first year of the plan, CSD received 14 complaints from AI customers regarding unsatisfactory performance of "scheduling or repair", and 20 complaints regarding unsatisfactory installation service. By 2000, those numbers had grown to 649 and 992 respectively, and excludes the 850 open service complaints that have not been closed and categorized. Ms. Jackson noted that specific complaints for poor performance by service technicians and customer service representatives have also increased. Ameritech Illinois' own data, GCI/City argue, also shows a pattern of serious degradation in critical service quality components.

GCI/City note Staff witness McClerren's assertion that the Staff has met with the Company for years to try to resolve the "out of service" problem, to no avail. His testimony shows that that in spite of the Commission's increased attention to the issue, the inclusion of a $30 million penalty in the SBC/Ameritech Merger Order for failing to meet the standard in calendar year 2000, and the Company's promises to the address the problem, AI *reduced* installation and repair technician staffing levels. Most of these technician headcount reductions occurred from August 1998 through January 2000, a period during which "increases in technician headcount were promised by the Company," according to McClerren.

The GCI/City also claim that AI's performance with respect to the "installation within 5 days" service quality measure has also been below par during the price cap plan, and particularly deficient in recent years. Mr. McClerren testified that the Company's installation performance has been unsatisfactory throughout the term of the plan. More specifically, the Company averaged more than five days for POTS installations throughout the January 1999 through September 2000 time frame, with the September 2000 time frames averaging more than 10 days.

According to GCI/City, AI also reported above-average delays in installation intervals for POTS service between June and August of 1999, at between 6.02 days and 6.41 days, when compared with average installation times of 5.86 days over the course of 1999. As noted above, installation intervals increased again during the August 2000 overtime restrictions.

Anecdotal evidence provided by AI's customers in a special meeting of the ICC and in complaints to CUB suggest that these numbers are deceivingly low given the fact that they do not capture Ameritech Illinois' performance for installation requests made in advance of a date certain. The anecdotal data regarding installation intervals for those customers suggests that they wait weeks or months for installation of service. (GCI Ex. 2.0 at 14.)

Despite AI's many service quality failings, the GCI/City assert that it has continued to cut costs by offering an early retirement package effective November 15, 2000 to management employees, including experienced field, area and general managers overseeing technicians in the field. And, it has also limited the amount of overtime each technician was allowed to work on at least two occasions in the last two years: June through August of 1999 and again in August of 2000. According to CUB, both of the limitations put on overtime coincided with sharp increases in the percentage of lines that were out of service for over 24 hours.

Deficient service quality not only affects AI's current customers, the GCI/City maintain, but also those few who have attempted to obtain service through a competitor. Most of the carriers attempting to compete with Ameritech Illinois are resellers that purchase the necessary equipment from AI leaving even those customers who have switched providers at the mercy of AI's failings.

City maintains that the Commission also should not limit its review to the eight service quality measures ordered in the 1994 Order because that would not give a full and accurate picture of the decline in service quality. While the Other Repair intervals of other Bell Operating Companies have remained relatively steady on average, the City claims that the Other Repair intervals not measured by the Plan experienced by Ameritech customers in Illinois have increased dramatically.

Finally, the GCI/City note that the record shows that AI's investment in outside plant has declined under the plan, which could explain the increased trouble and out-of-service conditions that occurred in recent years. AI's annual new investment in outside plant declined from about $35 per access line in the 1990-1991 timeframe to about $21 in 1994, increasing to about $29 in 1996 and declined to about $19.40 in 1999. Clearly, the Company's performance in critical service quality areas and the evidence of disinvestments in the POTS network point to the need for significant modifications to the service quality component of any new plan adopted in this proceeding.

All in all, GCI/City contend, the Company has utterly failed to "maintain the quality and availability of telecommunications services" under the existing price cap plan, as required by Section 13-506.1(b)(6) of the Act.

Staff's Position

Staff observes that original service quality standards were developed in the Alt Reg Order where the Commission stated that:

> Section 5/13-506.1(b)(6) requires the Commission to find that an alternative regulation plan will **maintain** the quality and availability of telecommunications services. [Emphasis added.]. . . . Therefore, we will adopt the Company's eight separate quality of service measures using the Company's average performance in 1990 and 1991 as performance benchmarks. Since the Company has exceeded the Commission's Part 730 rules, which are intended to be minimum standards which all LEC's must satisfy, it is necessary to establish these higher standards to safeguard against erosion of service quality. (Alt Reg Order, at 58.)

The Commission intended its actions to maintain service quality levels for the eight performance measures at the Company's actual performance in 1990 and 1991. Accordingly, Staff notes the Company's performance for those years was averaged to compute benchmark for seven of the measures. The eighth measure, % Out of Service > 24 Hours, was based on Code Part 730 since the Company performed below the minimum level required by Code Part 730.

Staff contends that the Company's reported service quality has been consistently substandard throughout the life of the plan. According to Staff, the Company missed the OOS>24 standard ten times in 1995, twelve times in 1996, twelve times in 1997, eleven times in 1998, three times in 1999, and four times through September 2000. Staff further states that in year 2000, the Company's OOS>24 performance was 14.4% in October, 5.6% in November, and is estimated to be 7.1% in December, 2000. Its year ending OOS>24 performance for calendar year 2000, Staff notes, is estimated to be 10.9%.

Staff's averaging of the Company's OOS>24 performance for the years 1990 to 1994 establishes Ameritech Illinois' "pre-plan" OOS>24 performance at 7.1%. Its averaging of the Company's performance for the years 1995 to 2000 shows AI OOS>24 performance to be at 12.0%, which would represent a deterioration of over 69%.

Staff also believes it instructive to consider the Company's OOS>24 performance for 1990-1991, since these years were used by the Commission to set the original eight benchmarks. When the Commission found that Ameritech Illinois' actual average performance had not met the Part 730 standard for OOS>24 for 1990 and 1991, it determined that the actual "average" could not be used, and mandated the use of the Part 730 standard for OOS>24. Assuming arguendo, that the Commission had agreed to simply "maintain" service quality for this standard and used the AI's average actual performance from years 1990 and 1991 to set the standard, the Company's performance during the life of the Alt Reg Plan still would have failed to meet the standard. The average for the Company's OOS>24 performance for the pre Plan years 1990 and 1991 provides a benchmark of 7.2%. Staff's averaging of the Company's OOS>24 performance for the years 1995 to 2000 shows Ameritech Illinois' performance at 12.0%. This represents a deterioration of over 66% from the average of 1990 and 1991 levels, meaning that Ameritech has been unable to "maintain" service quality at a level that was already substandard.

Under either analysis, Staff claims, Ameritech Illinois' OOS>24 performance has deteriorated significantly over the course of the Plan. Further Staff notes it has met with Company representatives for years to try to resolve the out of service problem. Even with such increased Commission attention to the issue and the Company's promises to the contrary, the Company reduced installation and repair technician staffing levels. From August 1998 through January 2000, when most of the technician headcount decline occurred, there were several meetings between Staff and Company representatives where increases in manpower were promised by the Company.

Staff argues that, despite its meetings with the Company personnel, plan penalties, additional merger penalties and repeated commitments to improve performance, Ameritech Illinois would still experience the worst out of service problem in the history of the Plan. For the month of September 2000, Staff notes, the Company reported an out of service rate of 37.0%. This, it claims, exceeds the allowed rate per Code Part 730 and the current Alternative Regulation Plan by a factor of seven.

Staff maintains that the Company's installation performance has also been unsatisfactory. The Company reports that it missed the "installation performance within 5 days" standard for four months in 1996 and one month in 1999. In addition, the Company had problems reporting information accurately, i.e. the installation performance for calendar year 1999 was restated in June 2000. And, Staff believes the Company's chosen definition of installation performance is inappropriate and thus results in an understatement of service quality performance failures.

Staff claims that Ameritech's failures are further evidenced by the steady and drastic increase in the number of service quality complaints received by the Illinois Commerce Commission's Consumer Services Division ("CSD") in the year 2000. Reports of complaints made directly to Ameritech also depict a dramatic increase in complaints through the life of the Plan. It is unrefutable Staff claims, that consumers have suffered from long delays in obtaining repair service and installation of service, and from significant of scheduling problems experienced at the hands of Ameritech representatives.

In reporting on performance, Staff also believes the Company has applied an inappropriate definition of "installation" performance for that measure. It notes that Part 730.540(a), which is the foundation for the performance benchmarks in the Alternative Regulation Plan, states the following about installation requests:

> The local exchange carrier shall complete 90% of its regular service installations within five working days after the receipt of the application, unless a later date is requested by the applicant.

Staff believes that the term "regular service installations" should not be construed to mean vertical services and should relate only to the provisioning of regular telephone service, i.e., dial tone. Vertical features, such as Caller ID, Three-way Calling or Call Forwarding, are supplemental or added features to dial tone service and Staff considers requests for such services to be "change" orders. So too, Staff claims, the Company's tariffs show that vertical services are "optional" or "custom" services and not regular service. (Tr. 1804-1807.)

Yet, Staff contends, somewhere between the advent of vertical services and today, the Company alone arbitrarily decided to add vertical services to their reporting of "regular service installations" performance data to this Commission. None of the other Illinois local exchange companies which Staff contacted include vertical features in their installation data compiled and reported to the Illinois Commerce Commission.

Staff notes that the hearing testimony of Ameritech witness Hudzik shows that the success rate for meeting the Installation within five days requirement for vertical services is probably "99 percent," and, perhaps higher. (Tr. 1935.) With vertical services removed from installation figures, Ameritech's success rate in 1999 was "between 88 and 90 percent." (Tr. 1938.) For the period of June, July and August, 2000, AI's rate for meeting the installation requirement, including orders for vertical services, was between "96.5 and 98.3" percent. With vertical service orders excluded, the Company's performance "would have been in the 70 percent range." (Tr. 1939). This evidence makes clear that Ameritech's actual performance in relation to this standard has been obscured by the inclusion of vertical services statistics.

Staff witness McClerren noted that there is a rulemaking proceeding underway to addressing Part 730, Standards of Service For Local Exchange Telecommunications Carriers. Among other things, Staff intends to review the definitions of measurements to ascertain that all parties are measuring performance in the same manner. In that proceeding, Staff claims, it will recommend that vertical services should not be included in the installation calculation, and also to have additional lines treated as regular installations. Staff believes, however, that the definitional changes it is proposing should not be viewed as an admission that vertical services should have been included in the "regular service installation" calculation under the current language of Part 730.

Staff notes that the Company barely made the "Operator Speed of Answer - Intercept" measure for the year 1995, failing the standard in four separate months. It also failed the same standard, on a "monthly" basis, once in 1996 and three times in 1997. The "Trouble Reports Per 100 Lines" measure was missed twice in 1995, four times in 1996, and once in 1997, according to Staff's monthly assessment.

Overall, the Plan has contributed to Ameritech Illinois' failure on OOS>24, Staff claims, because it has been less costly for Ameritech Illinois to incur and pay the penalty (approximately $4 million) than to pay the expenses required to upgrade performance to meet the standard (approximately $30 million). This concept Staff claims was at the core of its testimony in the SBC/AI merger docket and resulted in Condition 23 of the Order requiring a $30 million penalty if the Company failed to meet the OOS>24 standard.

Staff notes that Ameritech has acknowledged that it has missed the OOS>24 standard in 2000, and is in the process of distributing the $30 million worth of credits to customers.

Commission Analysis and Conclusion

Both the GCI/City and Staff conclude that the quality of service has seriously deteriorated under the Plan. They each produce a number of different analyses of the Company's performance under the Plan and suggest a number of different reasons for the decline on service.

We note that a number of these analyses are focused exclusively on the OOS> measure or single out monthly performance instead of benchmark, i.e., annual performance. In a similar view, we are provided with a list of failures again mostly concerning OOS>24 that occurred in year 2000. While valuable to some degree, this does not provide a full account and complete picture.

In doing so, we find that AI has provided acceptable service on most of the measures we set out in the Plan. We agree with Staff, however, that reasonable service in one area will not excuse poor or substandard performance in other areas. The OOS>24 hours measure has been singled out, and properly so, since it is a major component of service. Indeed, we recall the City's argument that when a customer cannot obtain telephone service because of a outage, no other performance measures really matter. To be sure, OOS>24 hours compliance was a matter of great concern when we fashioned the Order issued in Docket 98-0555. Yet, despite our increased attention to this matter AI again failed in its performance.

We cannot confidently identify from the record the single, definitive source of the Company's performance problems. As best we can determine, the manpower shortages due to unexpected retirements appears to coincide with the worst of the infractions. Regardless of the cause of service quality degradation, if we continue with the Plan, AI is put on notice that its service obligations must be the Company's top priority and that it must take whatever action is necessary to ensure compliance with those obligations. The record compels us to find that the Plan has failed to met the statutory service quality requirements.

10. The Public Interest

Authority: Sections 13.506.1(b)(1); 13.506.1(b)(4) and Alt Reg Order.

Section 13-506.1(b)(1) requires that any alternative regulation plan serve the public interest and subsection (b)(4) requires that it be a more appropriate form of regulation, based on the Commission's overall consideration of the policy goals set forth in Sections 13-103 and 13-506.1(a). The Commission concluded in 1994 that these standards were cumulative of all the Section 13-506.1 requirements and policy goals and could be resolved affirmatively if its conclusions on the other statutory requirements were positive. (Alt Reg Order at 188, 191).

GCI/City's Position

GCI/City maintain that review of the Plan operations demonstrates that the Commission and the legislative requirements and goals have only been partially met. They believe that AI's non-competitive and competitive rates are not just and reasonable; that services classified as competitive have seen rates increase; that service quality has deteriorated; that only minor innovations have been identified; that the expectation of effective, price constraining competition has not been fulfilled; that regulatory delay and costs are still prevalent, that the service basket structure has been manipulated to the detriment of consumers using the most inelastic and essential services; that AI has earned unreasonably high profits; and that POTS consumers have received only a marginal portion of the rate reductions required by the price cap plan (primarily through volume discounts on usage) or have actually paid increased rates as a result of subscribing to AI's Simplifive calling plan which was erroneously promoted as a lower priced plan.

According to GCI/City rate reinitialization is necessary to bring rates back to just and reasonable levels, and changes to the plan are necessary to bring it into compliance with the law and the Commission's goals. If the necessary changes are not made, they contend that AI should be returned to rate of return regulation.

Staff Position

In Staff's view, there is no persuasive evidence to indicate that the rates produced by the Plan for non-competitive services are not just and reasonable. Further, the Plan has generally reduced regulatory burdens and the need for regulatory oversight to some degree and has provided Ameritech additional pricing flexibility for certain services.

On balance, Staff notes several defects in the Plan have become apparent over its life. The most significant, service quality, has deteriorated markedly as per the Plan's indices. Further, Ameritech has structured its annual price cap filings to reduce consumer benefits under the Plan.

According to Staff, Ameritech has also prematurely and inappropriately reclassified a number of services as competitive, thereby removing them from the aegis of the Plan. While not directly at issue in this proceeding, Staff believes that this matter unquestionably bears upon the overall effectiveness of the Plan, and in its view, has compromised the efficacy of the Plan by reducing the benefits that consumers might otherwise have realized.

Staff believes that the first and second defects it has identified must be addressed in this proceeding if the Plan is to comply with the public interest. If the appropriate adjustments are made to correct these defects, Staff recommends that the Plan be extended.

Staff, however, does not recommend that that rates be reinitialized directly as a result of Ameritech's earnings achieved under the plan. Nor is it Staff's recommendation that Ameritech be returned to rate-of-return regulation.

Commission Analysis and Conclusion

As intended, we have examined the Plan's operations under each of the underlying particulars which now converge to bring the public interest question squarely into view. The issue before us now is whether the Plan has been and is a more appropriate form of regulation, and whether it has advanced the public interest. The ultimate issues are whether the Plan should be continued with any modifications, whether a new and different plan should be considered, or whether AI should return to rate of return regulation. It is crucial at this moment, that we step back to get a full and complete picture before making the ultimate assessment.

Taking an overall view of the Plan we see that a number of significant benefits were realized: rate reductions for non-competitive service customers went into effect each year; the Company invested in its network to an extent slightly beyond the $3 billion it pledged in 1994; the Company learned to become more business oriented and prepare itself for competition; and regulatory delays and costs were somewhat reduced.

We have also been disappointed in a number of areas:

1. The Company's service quality performance has deteriorated in the key areas of repair and installation of POTS, and this causes us great concern.

2. The notably sustained, high returns on equity AI has reported during the Plan lead us to conclude that the Plan has not produced fair, just and reasonable rates. An insufficient portion of AI's productivity and cost savings have been realized by consumers and competition has not arisen to protect consumers and supplant regulation. We conclude that the 1% consumer productivity dividend written into the price index has failed to capture a reasonable portion of the cost reductions realized over the course of the Plan.

3. We find that although the price index resulted in price reductions, the Company has crafted its price decreases in the residential basket to target high use consumers, and that simple POTS consumers have seen little if any rate reductions despite substantial cost reductions. AI continues to insist that the residential network access line rate is below cost despite our finding in the Alt Reg Order that the rate was above cost. We find elsewhere in this Order that AI's most recent cost of service study is unreliable and cannot be cited to justify AI's position. We further conclude that the Company's use of the "new services" designation has enabled it to increase rates for non-competitive residential usage in violation of our intent that residential access and usage rates not incrase during the Plan.

4. We agree with Staff that AI has fashioned its annual rate filings to retain more benefits than we intended.

5. Aithough AI has introduced several new pricing packages, it has not identified any service innovations introduced during the Plan other than Privacy Manager. Although we believe that service is a good example of innovation, we expected the Plan to incent significantly more innovation and find the lack of innovation disappointing.

Section 13-506.1(b)(4) requires the Commission to assess whether alternative regulation "constitutes a more appropriate form of regulation" based on the requirements and policies contained in section 13-506.1 and 13-103. 220 ILCS 5/13-506.1(b)(4). Similarly, section 13-506.1(b)(1) requires that the Plan be "in the public interest." In our 1994 Alt Reg Order we found that this provision "ÿtakes into consideration all of the policies and criteria set forth in response to Sections 13-506.1 (a) (1)-(6), 13-103 and 13-506.1(2) – (7)." Alt. Reg. Order at 191. Given our conclusion that several aspects of the Plan did not meet our expectations or statutory requirements, we find that the Plan cannot be continued in its current form and still be considered "in the public interest."

In assessing whether the Plan is a "more appropriate" form of regulation we must compare the results of the Plan against what we would have expected had the Company remained under traditional rate of return regulation. In the critical area of whether the Plan has created fair, just and reasonable rates, we must compare the rates that would result from a rate of return to AI's current rates to determine which approach produces rates that most fairly balance shareholder and ratepayer interests. The parties have presented rate of return analyses which includes an analysis of earnings, depreciation expense, the cost of capital, cost of service and rate design which are discussed at greater length later in this Order. These analyses showed that rates under rate of return regulation would be $2*** million (AI), $837 million (Staff) or $956 million (GCI/City) less than the rates produced by the price index.

There were a number of considerations which the Commission took into account when it adopted alternative regulation for the Company. Those same considerations compel us to conclude, here and now, that despite the problems we have identified with the Plan, alternative regulation is more responsive to meet the challenges of the current telecommunications market. We believe that technology and market forces are changing the entire telecommunications industry and over the next few years meaningful competition, in one form or another, will likely arise in most of AI's markets.

Based on the Commission's overall consideration of the policy goals and requirements set forth in Section 13-506.1 and the whole of the evidence in this proceeding, we find that the Plan constitutes a more appropriate form of regulation provided that we reduce rates and revenue levels to those consistent with what is reasonable under a rate of return analysis and the Plan is modified to better serve the public interest going forward. Despite Staff's position that rates should not be reinitialized, we note the several Staff witnesses presented an analysis of AI's earnings, and concluded that AI's rates produce $837million more than is necessary to provide a reasonable return on investment. We do not agree with Staff's conclusion that this high level of earnings is within a zone of reasonableness and should be allowed to continue without regulatory intervention. We conclude that if we do not adjust rates to just and reasonable levels, or reinitialize rates for a new plan going forward, we would not be able to conclude that the Plan has been in the public interest, is a more appropriate form of regulation, or should be continued. Clearly, a Plan that produces such high returns while service quality deteriorates and innovation stagnates, has not fairly balanced ratepayer and shareholder interests.

IV. RATE RE-BALANCING

AI's Position

In its rate re-balancing proposal, AI proposes to increase the monthly charge for residence network access lines by $2 per month across all access areas, while reducing other service rates to make the plan revenue neutral. The new residence access line charges, including the end user common line charge ("EUCL"), would be $8.90 in access area A, $11.88 in access area B and $15.35 in access area C. AI asserts that there has been no increase in network access line rates since 1990. Even with the proposed $2 increase in effect, the network access lines will have increased less than the inflation rate. Thus, AI asserts, even after the increase, the real costs of residence access lines would be lower than it was in 1990. AI projects the total revenue increase resulting from the residence network access line increase would equal $84.1 million.

AI has requested the increases to bring rates more into line with costs and to narrow the difference between residence and business access line prices. At current rates, AI claims its residence access lines are priced below LRSIC in access area B and C. Although current rates cover LRSIC in access area A, AI asserts that when shared costs and non–recurring costs are included, that rate is also below cost.

Moreover, AI asserts that LRSIC, as calculated under the Commission's Cost of Service Rule (the "Rule"), 83 Ill. Admin. Code Part 791, understates the incremental costs of network access lines. Section 791.70(d) requires that LRSIC be calculated based upon the assumption that the entire useable capacity of network facilities is used to provide service. "Usable Capacity" is the maximum physical capacity, less capacity required for maintenance, testing or administration. 791.20(n). In the real world, facilities are almost never operated at their usable capacity for a variety of necessary reasons. Therefore, more facilities are required to meet the demand for residence access lines than are included in the cost study. The "spare capacity" costs for these necessary, additional facilities are treated as common costs to be recovered from all services when, in reality, they should be considered part of the LRSIC costs of access lines. Spare capacity costs for residence network access lines are shown in AI Ex. 10.1, Schedule 9 (rev.) and are significant. If spare capacity costs were included, the LRSIC of access lines, on average, would increase by 80.2%.

When LRSICs (as computed under the Rule) are considered in conjunction with shared, non-recurring and spare capacity costs, access line prices are significantly below costs in all access areas, even if those services are not asked to contribute to the recovery of common costs. However, the Commission has recognized that individual services should make a reasonable contribution toward recovery of common costs in both the TELRIC proceedings and Phase II of Access Charge reform proceedings. Similarly, the FCC required LECs nationwide to develop forward-looking economic costs of service ("FLECs") that included an allocation of common overheads. These costs will be used by the FCC to determine eligibility for federal high cost funds. The Commission approved AI's FLEC methodology in Docket 97-0515.

In AI's opinion the under-pricing of access lines has adverse consequences for both customers and competitors. Competitors have shared costs and spare capacity costs too. When residence access lines are priced so low that they do not recover costs, or at least a substantial portion of them, AI claims its competitors are deterred from offering residence access line services which result in a lack of infrastructure investment. For consumers, AI claims low prices stimulate inefficient and excessive demand, which the Company is reluctant to build new facilities to satisfy because the service is unprofitable. Consequently, AI believes efficient consumption of services such as usage and vertical features is discouraged because these services must be priced too high in relation to their costs in order to make up for the shortfall in residence access line revenues.

To offset the increase in rates for residence network access lines, AI proposes to reduce one-time residence service ordering and installation charges by $21.6 million. Further, AI is offering to reduce Band B additional minute charges by approximately 12.7 million based upon the Company's perception that consumer would like to see the Band B rate structure move in the direction of the Band A per call rate structure. AI also proposes to reduce pay per use charges for three calling features: automatic callback, repeat dialing and three way calling, by about $5.1 million. Finally, AI has already reduced carrier access charges by $33.3 million pursuant to Commission Order in Dockets 97-0601, 97-0602, and 97-0516 (consol.) and expects further reductions of $10.5 million for a total overall carrier access reduction of $43.8 million.

Staff's Position

Staff believes AI's re-balancing proposal has numerous defects and recommends the Commission reject the proposal. First, Staff claims that AI is understating the amount of revenue collected from the provision of network access line services. Particularly, Staff asserts the understatement of revenue occurs from AI's estimate of revenues it receives from EUCL charge. As such, Staff concludes, even using AI's LFAM cost studies, AI's proposal cannot be justified.

Second, Staff contends that AI's LRSIC for network access line services show what the Company concedes are "substantially" increased compared to those the Company filed in its 2000 Aggregate Revenue Test filing.

Based upon AI's new model, LRSIC for network access line services increased from 34% to 53%, depending on the Access Area. Staff assets that without the above mentioned increases, revenues from network access line services would exceed LRSIC in all access areas.

Staff rejects AI's new model, the Loop Facility Analysis Model ("LFAM") and urges the Commission to do the same. Staff notes with skepticism that AI's new LFAM shows costs increasing dramatically while at the same time industry costs are declining. Staff points out that this Commission has never approved a cost study generated by, or costs derived from the LFAM model. Staff is not persuaded by AI's argument that its new model is able to identify and recover costs that prior models failed to identify and recover. Staff rejects AI's LFAM model for failing to conform with part 791 of the Code, specifically: the model uses futuristic network rather than planned network, use of incorrect fill factors, and it failure to reflect the demand for the entire service. Further Staff detected what it views as programming flaws. Staff contends that AI's interface of fiber vs. Copper break length assumption are inaccurate. Additionally, material costs contained within the model fail to account for any merger related savings.

Because of an uncertain demand effects, Staff, contends that AI's proposal is not revenue neutral. Staff claims that AI's proposal would actually result in revenue increases for AI. Staff's difficulty with the proposal is that AI proposes increases to services with relatively inelastic demands and decreases to services with relatively elastic demands.

Next Staff rejects AI's use of access charge reductions ordered in Dockets 97-0601, 97-0602, and 97-0516 (consol.) to offset rate increases. Staff claims that these specific rate reductions are not an appropriate way to offset any rate increases to network access line charges. Staff Initial Brief at 126. While Staff acknowledges generally that certain price reductions could be made if network access line rates were below LRSIC, such reductions must come from within the Plan itself. Staff contends that AI seeks to do is to improperly offset price increases with price reductions which were required outside of the Plan.

As a general proposition, Staff does agree that to the extent that revenues generated from providing network access line revenues are below LRSIC, rate re-balancing in some form might be appropriate. Only to the extent that AI could prove that a rate is below LRSIC would Staff consider a corresponding rate increase.

Staff then seeks to rebut AI argument relative to contribution for shared and common costs. Staff asserts that it is not necessary for every service to contribute toward shared and common services. Staff offers its own proposal should the Commission agree that residence network access line rates are below LRSIC. Staff suggests that there be a reduction in Band A usage rates. Staff states that its proposal would pass on benefits to nearly all customers as opposed to AI's rate reductions to optional and in its view unnecessary services. Further, Staff notes its proposal will negate or diminish the effect of increase costs on those consumers who can least afford an increase.

Staff concludes however, that based upon the LRSIC used in AI's year 2000 Aggregate Revenue Test, revenues for residence network access lines exceed LRSIC in all access areas. Therefore, Staff surmises, AI's rate re-balancing proposal must be rejected.

DOD's Position

The DOD supports AI's rate re-balancing proposal. DOD states that the proposal will however create a net increase in revenue for AI. DOD contends that it is beneficial to align rates with costs as the telecommunication industry transitions from a monopoly market to a competitive environment. DOD argues that network access line rates have been underpriced relative to it costs. DOD/FEA also contends that the AI proposal will reduce rates for certain services that have been priced above costs.

DOD proposes modifications to AI's rate re-balancing proposal. To address the concerns of Intervenors relative to issue of Universal Services, DOD/FEA suggests that those customers would otherwise be eligible for lifeline services be exempt from the rate increase proposed by AI. Further, DOD/FEA recommends that IXCs provide proof to the Commission that reductions in carrier access charges are flowed through to ratepayers. Next, DOD/FEA proposes that the Commission direct AI to reduce all monthly network access line charges, both residence and business, by an amount that equates on a revenue basis to the reduction in access charges that were not previously passed through to consumers. Additional consumer protection is necessary DOD/FEA argues, because historically, market forces have not lead to a flow through of rate reductions to consumers.

City/CUB Position

CUB, AG, and County ultimately adopt the arguments made by City. City also urges the Commission reject AI's rate re-balancing proposal. First, as a Universal Service policy consideration, AI's proposed increase may result in forcing low income customers to drop off the network. On balance, City claims that customers' overall bills will increase rather than remain neutral.

Like Staff, City is skeptical of AI's new LFAM model results given that AI had just a few months prior filed with the Commission its Annual Revenue Test report which indicated substantially reduced costs. City addresses what it views as flaws of AI's LFAM model. First the LFAM failed to use "Least Cost Currently Available" technology. Next, City assets that AI improperly included "common" costs of a switch in the port cost. City charges that AI improperly double recovered the costs of installing the network interface device. The AI LFAM failed to address what the City calls a line mix assumption. What the City suggest is that AI take into consideration the different costs associated with the costs per line of installing a new switch versus the costs of adding lines to an existing switch. City asserts that AI's data shows they considered the higher costs per line for new switches disproportionately which skews costs upward. City claims that AI's use of the "revenue ready" fee in the network access line LRSIC is improper as said fee can be attributable to several other services, not just network access lines. Further, City claims it is inappropriate to include the costs of receiving and processing payments for several services, as a costs attributable to network access line rates. Like the revenue ready fee above, City asserts the cost for receiving and processing payments should at the very least be spread across LRSIC for several services. City also rejects AI's use of "Cost of Capital" in its LFAM. Lastly, City contends that AI's LFAM considers an inflated "net investment."

City also rejects AI's attempts to include additional costs to network access line LRSIC. City claims the addition of "spare capacity" and advertising costs artificially inflates network access line LRSIC. City argues that the Commission cost of service rules require that LRSIC include only "usable capacity and not the additional spare capacity. Lastly, City asserts it is improper to assign 100% of advertising and related costs solely to network access lines.

City concludes that AI's rate re-balancing proposal should be rejected as it is not justified on a cost basis or any purported policy reason offered by AI. Like Staff, City asserts the year 2000 Aggregate Revenue Test report filed on March 31, 2000, indicates that AI's rates are already in excess of costs. Similarly, City objects to AI's use of optional vertical services as an offset to an increase in network access line rate.

AT&T's Position

In response to Staff's proposal to offset increase for network access line rate with a corresponding decrease in Band A usage rates, AT&T cautions the Commission not adopt any modification which would reduce rates simply to balance revenues rather than reduce rates based upon costs. Further, AT&T rejects AI's assertion that the Commission concluded in its Phase II Order that AI was entitled to revenue neutrality to compensate it for the reduction required in said order. Rather, AT&T asserts, the Commission concluded that AI was not entitled to revenue neutrality as a matter of right. However, AT&T acknowledges that the Commission would allow AI to seek out whatever mechanisms were available to it to attempt to recoup any lost access revenues. Finally, AT&T argues that should the Commission approve AI re-balancing proposal, AI must implement its estimated additional $10.5 million in network access line reductions at the same time any authorized rate increase is to take effect.

AI's Response

AI responds to many of the concerns of Staff, GCI/City and DOD. Generally AI argues that its new LFAM model is an improvement over the model previously use. AI's asserts its new model results in cost studies which are more accurate than that performed for the 2000 Aggregate Revenue Test. With respect to the arguments of Staff, AI states that it has met its burden and shown that current network access line rates do not cover LRSICs. AI relies upon it updated costs model, the LFAM. AI states that it did not understates access line revenues. Also, AI amended its revenue analysis to take into consideration Staff's concern over account demand changes. Lastly, AI again asserts that it perfectly acceptable within the Alternative Regulation Plan to offset a portion of the proposed network access line rate increases with the carrier access charge reduction required in Dockets 97-0601/97-0602. In response to Staff's alternative offset proposal, reduction of Band A rates, AI argues that based upon current usage, further reduction is Band A rates will cause costs for said service to increase above LRSIC.

With respect to the arguments of City, AI states that its costs study is accurate and reliable and supports increasing access line rates. Additionally, AI asserts that other services may be currently priced above cost to make up for the shortfall which exists because network access line rates are priced below cost. Lastly, City's argument that basic residential services rates cannot be increased because of the moratorium against said increases imposed in the Order, must be rejected. AI asserts, the moratorium was for a specific period of time, five years. Given that the five year period has elapsed, AI contends it may properly seek rate increases for residential services.

AI rejects DOD's proposal to exempt certain customers from its proposed rate increase. AI asserts that the simultaneous reductions of rates to other services will offset its proposed rate increase. Further, that because services associated with new service will be see rate reductions, AI opines that telecommunication services will become more economically accessible.

Commission Analysis and Conclusion

The Commission concludes that the rate re-balancing proposal of AI must be rejected in its entirety at this time. Despite AI's protestations to the contrary, Staff and City fully set forth several deficiencies with the LFAM. Particularly troubling is the LFAM's lack of compliance with part 791 of the Administrative Code. Also troubling is the apparent programming flaws detected by Staff and City. We note that City lists no less than seven deficiencies with AI's LFAM.

What is telling about the new model's reliability or lack thereof, is the significant change in costs resulting in the use of the LFAM model from the use of the 2000 Aggregate Revenue Test. Both tests were done within just a few months of one another. AI would have the Commission believe that it's model used in the 2000 Aggregate Revenue Test was so deficient that it failed to capture up to 1/3rd of the total actual costs for network access lines. To say the least, the Commission is skeptical of the LFAM's ability to find never before found costs. Further, the Commission rejects the LFAM model to the extent that it fails to comply with requirements of Part 791. Staff correctly points out that this Commission has never approved a cost study generated by, or costs derived from the LFAM model nor do we choose to today. Ultimately, AI has failed to meet is burden in convincing the Commission that its costs for network access lines are above LRSIC. For that reason, the Commission rejects AI's rate re-balancing proposal.

V. GOING FORWARD

A. The Existing Components of the Price Cap Formula.

The existing alternative form of regulation replaces the typical, periodic rate case with annual price changes for noncompetitive services tied to a price index. The process requires AI to make an annual filing which interested parties can comment on and which the Commission reviews to insure compliance with its Alt Reg Order and the price index. The annual price changes are effective on July 1 of the year of the filing.

The price cap index, or the "PCI", is recalculated once each year to reflect recent inflation and other factors. The PCI can be generally described as:

PCI = Inflation factor (GDPPI)

minus the "X" factor (4.3%) (productivity offset)
minus 0.25% for each missed service quality benchmark,
plus/minus any Commission approved "Z" factor (exogenous change)

Terms used in the PCI are generally described as follows:

<u>Inflation Factor</u>: inflation is represented by Gross Domestic Product Price Index, ("GDPPI") which measures economy wide inflation for all goods and services;

<u>X factor</u>: the X factor represents the extent to which AI (or the telecommunication industry in general) experiences productivity growth which exceeds that of the overall economy (economy-wide productivity gains are already reflected in GDPPI) and any consumer dividend which the Commission may include;

<u>Z factor</u>: the Z factor captures "Exogenous changes," which are externally driven costs or revenue changes which impact AI uniquely or disproportionately reflective to the overall economy; and

<u>Service Quality Factor</u>: the service quality factor established benchmarks for service and imposes penalties if service quality declines.

More precisely the PCI formula is as follows:

$PCI_t = PCI_{t-1}$ [1+ (% change in the GDPPI)/100-.043 +/- Z - Q] where:

PCI_t = price cap index for current year,
PCI_{t-1} = price cap index for previous year,
GDPPI = Gross Domestic Product Price Index,
Z = exogenous change factor, and
Q = quality of service component, which is negative.

Additionally, the Plan placed most of AI's noncompetitive services into four distinct customer groups or service baskets. They are as follows: 1) Residential Basket, 2) Business Basket, 3) Carrier Access Basket and 4) Other Services Basket. The prices for the services within each of these baskets are allowed to fluctuate over time such that each basket's Actual Price Index ("API") never exceeds the PCI. The requirement that API for the baskets are less than PCI has placed the emphasis of AI's annual filings on the calculation of the PCI and the justification of each of its inputs.

Each basket's API is a reflection of the basket's average price once demand and any proposed tariff changes are properly accounted for. The API may change at any time during the year when price changes are made. (Order, Appendix A at 3). The API for an individual basket is calculated as follows:

$$API_t = API_{t-1} * \sum_{i=1}^{n} v_i \frac{P_i(t)}{P_i(t-1)}$$

where:

API_t = actual price index for the current year,
API_{t-1} = actual price index for the previous year,
i = rate element i,
$P_i(t)$ = proposed price for the i_{th} element,
$P_i(t-1)$ = current price for i_{th} element, and
v_i = revenue weight for i_{th} element.

The Commission has established a very specific set of filing requirements which the Commission uses to determine whether it should approve AI's annual rate filings with or without modifications. The 1994 Alt Reg Order

Illinois Bell shall be required to make an annual rate filing no later than April 1 of each year of the plan after 1994. At that time, Illinois Bell shall provide the following information:

(a) the price cap index for the following 12-month period (July to June), with supporting data showing the GDPPI for the previous calendar year and the percent GDPPI change for that 12-month period;

(a) the actual price index ("API") for each service basket, including the effects of proposed rate changes under the price cap index for the following 12-month period (July to June) and adjustments for new services added, existing services withdrawn, and services reclassified as competitive or noncompetitive;

(a) tariff pages to reflect revised rates;

(a) supporting documentation demonstrating that any proposed rate changes are consistent with the requirements of the price index mechanism;

(a) a demonstration that Illinois Bell would be in compliance with Sections 13-507 and 13-505.1 of the Act if the proposed rate changes went into effect;

(a) an identification of any changes to the GDPPI weights and an assessment of the effects of such changes, and any necessary modifications to the PCI;

(a) the current data showing the calculation of Z for the previous calendar year, with the events causing Z to change identified and described;

(a) the current data showing the calculation of Q for the previous calendar year, with the events causing Q to change identified and described.

(Order at 92). The Order further provided that "Staff and all of the interested parties will have an opportunity to file written comments in response to each annual filing and the Company will have an opportunity to file reply comments." (Id. at 93).

B. Proposed Modifications to the Price Cap Index.

1. Measure of Inflation

One component of the PCI is the Inflation factor which is derived by using GDPPI. The GDPPI measures the annual economy wide inflationary change over a given time period. GDPPI is published by the Bureau of Economic Analysis, U.S. Department of Commerce ("BEA"). At the time of the 1994 Alt Reg Order, a fixed weight version of GDPPI was the accepted and published output measure of inflation for the economy.

Since the entry of the Order, a "chain weighted" GDPPI has replaced the fixed weight GDPPI as the most commonly used inflation measure in the economy. Staff, as well as AI and GCI/City acknowledge that the methodology used to compute the chain weighted GDPPI is closer to the methodology used to compute AI's input prices. The methodologies used to compute the chain weighted GDPPI and AI's input prices allow for changes in the composition of output or input, whereas the methodology used compute fixed weight GDPPI does not. The parties agree that it is more proper to use the chained weighted GDPPI in the future as the inflation index.

The Commission concludes the use of a chain weighted GDPPI shall be substituted for the fixed-weight version in the price index on a going forward basis.

2. X Factor

Under the Plan, the "X" Factor in the price cap formula consisted of three elements: productivity differential, input price differential, and consumer dividend. The productivity differential measures the difference between telecommunications total factor productivity gains and overall economy total factor productivity gains. The input price differential measures the difference between telecommunications input prices and economy wide input prices; The third element of the X factor, the consumer dividend, is a judgmental factor adopted by the Commission based upon its expectations regarding gains that arise from technological and/or regulatory change and intended to insure that consumers benefit from productivity gains and cost savings. Under the current Plan, the productivity differential was set at 1.3%, the input price differential was set at 2.0% and the consumer dividend was set at 1.0%. (Order at 38.) This resulted in an X factor of 4.3%.

Under the Plan the productivity and input price differentials were based upon AI's productivity and input price performance versus the economy as a whole, as opposed to industry productivity and input price data. Industry productivity and input price data was not then available. Staff proposes that both productivity and input price differential be based on industry rather than AI specific data. AI, concurs.

a. Productivity Differential & Input Price Differential

AI and Staff's Position

AI sponsored the testimony of Mark E. Meitzen in support of its proposed productivity differential. Meitzen provided an analysis of the local exchange industry's total factor productivity ("TFP"). Meitzen's analysis used the Total Factor Productivity Review Plan ("TFPRP") which was developed by the United States Telecom Association ("USTA"). Meitzen concluded that 3.3% is appropriate for the productivity differential and input price differential. Similarly, Staff relies upon the USTA productivity study and also recommends adopting the 3.3% figure for productivity differential and input price differential. (Staff Initial Brief at 36.)

AI proposes a productivity differential and input differential of 3.3%, with no consumer dividend for an overall X factor of 3.3%. Staff recommends a productivity differential and input differential of 3.3% plus a 1% consumer dividend for an overall X factor of 4.3%.

GCI/City's Position

GCI/City maintain that an overall X factor 4.3 has proven too low, as explained in more detail in section III.1 above. GCI/City recommend that the Commission adopt a 6.5% X-factor. This 6.5% figure is taken from the FCC price cap order, which adopted the "CALLS" settlement proposal, whereby interstate prices are reduced by a 6.5% offset against inflation. GCI/City point out that although the FCC referred to the 6.5% as an "X- factor," it declined to call the 6.5% figure a productivity number, instead calling it a "transitional mechanism that operates to reduce rates" as requested by the carriers (including AI's parent SBC) as part of the CALLS settlement proposal.

GCI/City argue that the current 4.3% X-factor has allowed IBT to attain earnings many times above the authorized rate of return. Although GCI/City acknowledge that the price cap plan did not restrict earnings, on the assumption that higher earnings would incent the Company to cut costs and develop innovative services, GCI/City maintain that the magnitude of IBT's earnings in 1999 demonstrates that the X factor has not captured even a reasonable portion of IBT's cost savings. GCI/City argue that the record shows that despite years of elevated returns, market forces have not been able to "chip away" or reduce IBT's profit level or market share, demonstrating the regulatory action is required to supplant market forces. GCI/City argue that the X-factor is intended to mimic competitive forces and maintain IBT's rates and earnings at reasonable levels.

GCI/City rely on Dr. Selwyn's calculation of what productivity factor would have resulted in IBT earning the authorized return on equity of 11.36% as a check on the reasonableness of the 6.5% offset. GCI/City argue that Dr. Selwyn's "implicit X-factor" analysis shows that IBT's actual productivity during the course of the plan was 11.06% and that this shows (1) that the 4.3% offset has been unreasonably low; (2) that a 6.5% productivity offset "is clearly within the realm of possibility for achievement for Ameritech Illinois"; and (3) the company could still achieve and retain the benefit of efficiencies beyond that 6.5% offset. GCI/City point out that IBT's reported earnings of 19.15% for intrastate operations (later reduced to 18.82%) and 23.89% for total company operations for 1999 further justify a 6.5% X-factor showing that the Company has realized cost reductions to the extent that a 6.5% X factor would reflect about half of it annual realized productivity. The 6.5% X-factor recommended by GCI/City already incorporates a consumer productivity dividend.

If the Commission declines to adopt the 6.5% X factor proposed by Dr. Selwyn, GCI maintain that the Commission should retain the 1% consumer dividend in the X-factor as an increment to the productivity figure to insure that ratepayers receive "the first cut from any improvements beyond historical performance which arise from technological or regulatory change." Alt. Reg. Order at 39.

The City, in its initial brief, incorporates the position of AG. AG ultimately concludes that the goal of the X factor is to maintain AI's rates and earnings at reasonable levels. AG does not criticize, as CUG does, AI and Staff's reliance upon AI's TFP as a predicate to rejecting the 4.3% X factor. AG does however reject the 4.3% X factor as being too low. Under the current plan AG contends the 4.3 X factor has failed to curb what it deems as AI's excessive earnings. Like CUB, City and AG recommend the use of a 6.5% X factor.

County also calls for the adoption of a 6.5% X factor as used by the FCC for intrastate services. Like AG and City, County does not specifically criticize AI's TFP study but does reach a similar conclusion that the current 4.3% X factor is inadequate. County asserts that had there been in place an X factor of 11.06% from the inception of the alternative regulation plan, AI on total company basis would have achieved an annual return of 11.36%. County is not advocating the use of an 11.06% productivity factor but presents this information to highlight how reasonable a 6.5% X factor is.

In order to ensure that AI's noncompetitive rates are established at just and reasonable levels, GCI/City recommend the adoption of a 6.5% X factor. The 6.5% figure is taken from the FCC price cap order, which adopted the "CALLS" settlement proposal, whereby interstate prices are reduced by a 6.5% offset against inflation. Said 6.5% X factor includes a .5% consumer dividend. GCI/City rely upon the testimony of Dr. Selwyn. Selwyn testified that the 6.5% X factor would be appropriate because it is based on unseparated total company productivity results; it is based on FCC Staff's analysis of local exchange company productivity and input price differential for the 1985-1995 time period; the FCC Staff analysis was based on physical output measures (first local calls and later minutes of use); and it was accepted by the BOC's as part of the overall CALLS Proposal.

City/CUB acknowledge that the FCC declined to call the 6.5% X factor as used in the CALLS Proposal, a "productivity number" but instead the FCC chose to call it a "transitional mechanism that operates to reduce rates." No matter what the label, City/CUB contend, the FCC X factor and the Illinois X factor serve the same purpose, that is to mimic competitive forces and maintain AI's rates and earning at reasonable levels. Despite the FCC's reluctance to call its X factor a productivity number, CUB urges the adoption of the 6.5% X factor as it serves the same purpose, no mater what the label.

Parties' Responses

AI opposes the adoption of the FCC's 6.5% X factor in this proceeding. AI opines that the FCC's X factor is not a valid productivity measure. AI witness Meitzen testified that the FCC X factor was designed not as a productivity measure but a transitional mechanism imposed to reduce interstate carrier access rates. Ultimately, Meitzen concludes that the 6.5% X factor would serve to transform the Illinois X factor into a mechanism that reduces rates at a certain pace but would not be linked to a specific measure of productivity. (AI Ex. 2.2, at 19.)

AI numerated other flaws with the FCC X factor. AI claims that the FCC staff used outdated data and improperly used only a single physical measure of local output. Further, the FCC's output specification did not match the sources of revenue growth. Also, AI argues the use of a residual earnings method to estimate capital costs by the FCC was improper.

Staff contends that the study used by the FCC to arrive at its 6.5% X factor is flawed. Staff argues that it produces inaccurate output growth, input price growth and productivity growth estimates. Specifically Staff cites the following flaws with the FCC study: 1) proxying local output by local calls only, when in fact local output consists of many services including lines and vertical services which grow at different rates than minutes, 2) excluding miscellaneous revenues from the output measure, and 3) inappropriately computing capital input prices based on realized rather than expected rates of return. Staff Ex. 16.0 at 10-16. Like AI, Staff notes that the FCC no longer characterizes its X factor as a productivity offset but considers it a policy instrument. Staff Reply Brief citing Ameritech Ex. 2.2 at 19 (Sixth Report and Order) Staff urges the rejection of GCI/City's 6.5% X factor as methodologically flawed and greatly in excess of AI historical productivity growth.

GCI/City responded that although the 6.5% CALLS number was offered in response to FCC analyses, 6.5% X factor was not proposed by the FCC, so the methodological problems cited by AI are irrelevant. They point out that the 6.5% X factor was proposed by the RBOCs as an acceptable figure to resolve the FCC's updated price cap proceeding which contained proposed productivity, or X, factors, of between 5.5 and 8.51%. Further, GCI/City maintain that because the CALLS X factor was based on unseparated data, it should be as acceptable in the intrastate jurisdiction as it was in the interstate jurisdication.

b. Consumer Dividend

AI and Staff have divergent views with respect to the inclusion of a consumer dividend. Staff supports maintaining a 1% Consumer dividend in the Price Cap Formula. AI urges the Commission not to extend a consumer dividend for another term of the Plan. AI suggests that the consumer dividend was made apart of the Plan "to ensure that customers received 100% of the benefits of the Company's <u>first</u> productivity gains under the plan." (AI Brief at 40.) However, AI contends that the consumer dividend actually had the effect of flowing through all of the productivity gains that AI achieved during the first five years of the plan and an additional .8 % that AI did not achieve. (Id.) AI argues that the Commission did not have the benefit of real data when it imposed a 1% consumer dividend in the initial Plan. Now, however, AI concludes, based upon actual experience, the imposition of a consumer dividend in unwarranted on a going forward basis.

Staff urges the Commission to extend the consumer dividend and recommends such dividend be 1%. Staff contends that in inclusion of a consumer dividend fulfills the requirement under Section 13-506.1 (b)(5) of the Act wherein an alternative regulation plan must specifically identify how ratepayers will benefit from efficiency gains, costs savings resulting from regulatory change and improvements in productivity due to technological change. Staff takes issue with AI's statement that the consumer dividend had the effect of flowing through all the productivity gains made by AI. Staff contends that on a company wide basis, AI passed along less than half of its productivity gains during the initial five years of the plan. Further, Staff notes, AI passed along no productivity gains of its competitive services. Staff suggests that AI's real problem with the consumer dividend is that prices of non-competitive services fell by more than overall company productivity gains. Staff Reply Brief at 16.

GCI/City recommend that a consumer dividend be included in the PCI formula should the Commission rejects its suggested 6.5% X factor. A consumer dividend acts as an incentive to the incumbent carrier to improve its overall efficiency. It also acts as a form of consumer protection to allow a consumer to receive some specific benefits of price cap regulation. Further, GCI/City argue that AI's position that a consumer dividend should be eliminated because it achieved less cost savings than the price cap flowed back to consumers must be rejected as refuted by the record which GCI/City contend shows AI's earnings skyrocketed under the plan in spite of price index rate reductions.

Commission Analysis and Conclusions

The Commission notes that in our original order we stated that we would use results from other jurisdictions "as a frame of reference for the analysis of results in Illinois, and for the identification of any emerging or potential problem areas." <u>Id</u>. at 35. We agree with GCI/City that the results of the FCC price cap proceedings are relevant to our conclusions in this docket, and that the high level of IBT's earnings demonstrates that the existing 4.3% X-factor has not captured a reasonable portion of IBT's past productivity. We agree with GCI/City that the characterization of the 6.5% X-factor as a mechanism to reduce rates, rather than as a "productivity" factor, is not dispositive, and that its function in the FCC price cap plan, being an offset to inflation, is identical to the function of the X-factor in the price cap formula under the IBT alternative regulation plan. Further, the agreement of the SBC/Ameritech to the 6.5% X-factor for a five year period and the fact that was based on total company operations lead us to agree that it is the most appropriate X-factor going forward. We believe that the 6.5% X-factor we adopt does not require that we adopt a separate consumer dividend.

3. (Z) Factor

The Z factor accounts for any impact associated with changes made to the Federal Communications Commission's ("FCC") rules, and/or with some other change which is quantifiable and outside AI's control, and has not been picked up in the economy wide inflation factor. We have previously held that exogenous factor treatment should be allowed only for costs: 1) which are truly outside the Company's control; 2) which are not picked-up in the economy-wide inflation factor, to avoid double-counting; 3) which are verifiable and quantifiable, to ensure that the effect of the exogenous event can be accurately determined without protracted, controversial regulatory involvement; and 4) the changes must exceed $3 million.

AI's Position

AI proposes that the Z factor continue to be a component of the price cap index mechanism and that on a going forward basis, the Commission expressly recognize the exogenous treatment of Commission mandated rate reductions.

Under the current plan an exogenous change, if approved by the Commission, is inserted into the formula and is allowed to take place at the next annual filing. AI proposes that exogenous treatment for rate reductions should be allowed to take place immediately, without waiting for the next annual filing under the Plan. (AI Initial Brief at 41.)

Staff's Position

Staff also proposes that the Z factor continue to be a component of the price cap index mechanism. Staff acknowledges that the Commission would want flexibility built into the price cap plan to deal with issues that cannot be satisfactorily dealt with elsewhere and the Z factor is a place where such discretion could be exercised. (Staff Initial Brief at 19.) On a going forward basis, Staff proposes that AI must file for exogenous change treatment within 30 days of a Commission mandated revenue reduction with the specific rates it wishes to change. Staff would then review the proposed rate changes. Final rate changes necessary for revenue recovery would then be implemented no later than 60 days after the initial AI filing. Additionally, Staff proposes that Commission reserve the ability to delay rate changes until the annual price cap filing, as well as deny revenue neutrality. Further, Staff states that the Z factor is not intended nor should it be used as a earnings management tool.

GCI/City's Position

GCI maintain that the Z-factor should not be changed. They argue that the four threshold factors currently considered are necessary to limit exogenous treatment to appropriate circumstances, and to insure that the Commission can exercise its discretion when reviewing a request for a revenue increase. They challenge the Company and Staff's approach as being essentially a revenue preservation tool, which is inconsistent with alternative regulation, as denying the Commission necessary discretion, and as being circular, in that Commission ordered decreases can be turned into rate increases irrespective of need or the basis of the original revenue reduction order.

GCI/City argue that the 60 day period for review is too short to truly test the validity of the demand assumptions underlying the request, to enable effective participation by parties, and constitutes another layer of regulatory filings to burden the parties. GCI/City claim that 60 days is inadequate to determine the revenue effect of a rate change because to the lack of reliable demand data. GCI/City are also concerned that a Commission ordered rate reduction in circumstances unrelated to non-competitive rates could result in a non-competitive services rate increase. Lastly City/CUB argue that one of the intended benefits of alternative regulation was to decrease regulatory burden. A single annual filing was intended to accomplish reduced regulatory burden. The Z factor proposals suggested by AI and by Staff serve to increase regulatory burdens by creating a new category of cases which Staff and other interested parties would have to examine, and examine on an expedited basis.

GCI/City also point out that allowing automatic offsets for all Commission mandated rate changes limits the Commission's discretion to determine whether rates are just and reasonable absent the offset. GCI/City argue that under the AI proposed change, AI would receive more favorable treatment under price cap regulation than it would have received under rate of return regulation. Under rate of return regulation, rate changes are only allowed upon a showing that said change is necessary to maintain just and reasonable rates.

AT&T's Position

AT&T also opposes AI's request that the Commission expressly recognize that exogenous treatment of Commission mandated rate reductions are appropriate under the Plan. Should the Commission adopt AI's proposal, AT&T envisions a situation wherein AI would be entitled to exogenous treatment where the Commission mandated a rate reduction as result of a Commission determination that AI's rates were unjust and unreasonable. AT&T also opposes AI's proposal for immediate reductions

Commission Analysis and Conclusion

The Commission concludes that the Z factor continues to be a necessary component of the price cap index formula. The Commission found in the 1994 alternative regulation order that an exogenous change factor is necessary because a price cap formula is an over simplification of complex issues of public policy. Order at 61. The Commission recognized then, as it does now, that the formula, without a Z factor cannot always reflect changing circumstances and balance competing interests fairly. We believe that the Z factor has operated as expected over the course of the Plan and decline to adopt the changes proposed by AI and Staff.

We agree with GCI/City that expediting exogenous treatment would add a layer of regulatory proceedings, not give parties sufficient time to accumulate and analyze the relevant data, and inappropriately limit our discretion. Further, AI and Staff's proposals would introduce rate of return concepts, or revenue preservation concepts, into the price cap plan. If AI claims an event has occurred which it feels requires exogenous treatment, AI must satisfy the four criteria as set out in the 1994 Alt Reg Order at 62, regardless of whether such an event was a result of a Commission mandated rate reduction or otherwise.

4. Service Quality/Q Factor

The Act requires that an alternative regulation plan serve to maintain the quality and availability of telecommunications services. 210 ILCS 5/13-506.1 (b)(6) Under the Plan the Commission concluded that the best way to eliminate AI incentive to reduce service quality will be to adopt a service quality component to the price cap formula which penalizes AI for not maintaining service quality. Under the Plan the Commission adopted eight separate quality of services measures. For each measure, AI receives a score of zero if it meets the benchmark, and a score of -.25 if it fails to meet a specific benchmark. Without the benefit of history, the Commission concluded that its Q component would provide considerable incentive for AI to meet its benchmarks. Order at 59.

Staff recommends that the Q factor be eliminated from the price cap index. Staff has recommended that the issue of service quality be addressed outside the price cap index in separate proceedings. AI, GCI/City have alternative proposals as to how to handle the issue of service quality, but also prefer that service quality be addressed outside the index.

Commission Analysis and Conclusion

We agree with Staff and GCI/City and conclude that the issue of service quality be addressed within the alternative regulation plan but outside the scope of the price cap index itself. A detailed examination of the issue of service quality can be found in the Service Quality Section of this order.

C. Pricing Flexibility

The current Plan provides that rates for services within each service basket can be changed by up to 2% over the price cap index, provided that overall, the change for the entire basket is no more than the price cap index. This limitation on pricing flexibility within the price cap was adopted to give the Company some pricing flexibility while moderating the effect of price changes on consumers of non-competitive services.

AI's Position

AI recommends that the Plan be modified on a going forward basis to allow the Company greater flexibility to increase prices. According to AI, pricing flexibility would "allow it to 1) adjust rates to the more competitive marketplace, and 2) allow it to move toward a more "economically efficient rate structure." (Staff Reply Brief at 21, citing Ameritech Initial Brief at 6.) Under the Plan, AI's pricing flexibility is limited to 2% over the percent change in the PCI and a rate cap was imposed on basic residential services for five years. (Ameritech Initial Brief at 42, citing Order at 64-65, 70.) AI complains that because of the severe limitation placed upon it, it has not been able to increase noncompetitive rates since the Plan went into effect.

In support of its argument for increased pricing flexibility AI argues that its residence network access lines are priced too low and being subsidized by other services. AI contends that reasonable per service rate increases be allowed to effectuate a smoother transition to competition and a more efficient rate structure. AI has alternative proposals relative to pricing flexibility. Should the Commission grant its request for rate re-balancing, then AI requests the ability to increase individual rate by 5% annually over existing levels, while at the same time decreasing rates of other services to maintain compliance with the PCI. (Ameritech Initial Brief at 42.) AI asserts less upward pricing flexibility is needed if rate re-balancing is accepted. Should the Commission reject AI's rate re-balancing proposal, then AI requests authority to increase individual rates up to 10% per year with a cap of 30% during a 5 year period. Id.

AI asserts that Staff's and GCI/City's objections to pricing flexibility are unprincipled. AI contends that Staff and GCI/City's view is shortsighted in that both fail to see the harm to ratepayers when AI's rates fail to cover their costs and are unsustainable in a competitive marketplace. Further, AI asserts that pricing flexibility allows for more gradual increases as opposed to sudden changes in prices resulting from proceedings such as rate re-balancing. (Id at 43.)

Staff's Position

According to Staff, AI has failed to explain why it needs any significant level of pricing flexibility for services for which it has no competitors. Should either of AI's proposals be approved, Staff contends the upward pricing flexibility allows AI to increase noncompetitive rates where no competitive pressure exists. This type of conduct, Staff asserts, is called "Ramsey pricing." Basically, Staff charges that AI pricing flexibility proposals are nothing more than a desire to charge customers more with no fear of losing customers to competitors. Staff concludes that the 2% pricing flexibility remains appropriate and should be implemented going forward.

GCI/City's Position

GCI/City argue that AI's request for increased pricing flexibility is based on its erroneous view that residential network access line charges are below cost and need to be increased. GCI /City agree with Staff that AI's claimed "consumer preferences" and "increasingly competitive marketplace" do not justify large rate changes for <u>non-competitive</u> services. Further, they point out that IBT has raised non-competitive rates during the course of the plan, referring to the Simplfive and CallPak 100 rates, which increased band A rates and many band B rates. Finally, they argue that the increased pricing flexibility IBT seeks would harm consumers by disadvantaging residential POTS customers and enabling the Company to impose Ramsey pricing, an outcome the Commission expressly intended to avoid when alternative regulation was originally adopted. Alt. Reg. Order at 69. GCI/City agree with Staff that the 2% pricing flexibility should be retained.

The Citizens Utility Board, the Attorney General and the City of Chicago maintain that regardless of the pricing flexibility allowed in the plan, under section 13-506.1(c) of the Act, rates for basic residential service (access and band A and B usage) cannot be increased. They argue that the plan approved in ICC Docket 92-0448 was a five year plan and that any plan approved in this docket constitutes a new plan, triggering the rate cap requirement of section 13-506.1(c). These parties also maintain that it is good public policy to maintain the cap on residential access and usage. As discussed later in this Order, they recommend that residential access rates be reduced to reflect cost. Given that these rates are already significantly above cost, and IBT's stated intention to raise them, these parties argue that a rate cap is necessary to protect residential consumers of the least elastic telecommunications services (access and band A usage).

Commission Analysis and Conclusion

The Commission concludes that the current 2% pricing flexibility afforded to AI be maintained on a going forward basis. Essentially, AI's difficulty with the current 2% upward pricing flexibility limit is that it has not been able to increase rates despite cost decreases. The rationale for increasing pricing flexibility is not supported by the record. There is little or no evidence indicating AI's non-competitive services have suffered market share loss or that it has been unable to react to market forces. AI's argument that its residential network access line cost is greater than the residential network access price is not supported by the record, as indicated in our discussion of rate rebalancing and AI's new cost of service study.

C.1.. Residential Rate Cap

GCI/City argue that a residential rate cap should be continued in any plan approved by the Commission in this docket, pursuant to Section 13-506.1(c) of the Act. These parties argue that the statute requires the implementation of the cap for both legal and policy reasons. Section 13-506.1(c) of the Act provides:

> An alternative regulation plan approved under this Section shall provide, as a condition for Commission approval of the Plan, that for the first 3 years the plan is in effect, basic residence service rates shall be no higher than those rates in effect 180 days before the filing of the plan. [1]

220 ILCS 5/13-506.1(c). CUB states that unless a residential rate cap is included in the plan, even price changes falling within the existing two percent pricing flexibility factor would constitute illegal increases for basic residence service under 13-506.1(c).

CUB also supplies policy reasons why a residential rate cap should be included in any plan approved by the Commission. First, the conditions that caused the Commission to include the cap in the existing price cap plan in order to ensure that the conditions set forth in Section 13-506.1(b) are met have not changed. Residential NAL and usage service (Bands A and B) remain noncompetitive services subject to negligible competitive threat. By including these services under a rate cap, and making the additional modifications to the formula recommended in this Brief, "the customers whose demands are the most inelastic" will, again, "be protected from the exercise of monopoly power during the pendency of this plan." See Price Cap Order at 64. When combined with the rate reinitialization and modifications to the formula recommended by GCI/City, extension of the residential rate cap will help ensure that rates produced under the plan are "fair, just and reasonable", as required under Section 13-506.1(b)(2) of the Act, CUB argues.

Second, CUB submits that the Commission's concern with satisfying the statutory and policy goal of universal service has not changed in the six years since the price cap plan began. Indeed, the Commission's concern with ensuring that residential service remain affordable for all customers should be heightened, given the decline in universal service Illinois has experienced during the life of the price cap plan. See GCI Ex. 8.0 (Dunkel Direct) at 6-11. The Commission's recognition of the "general principle of microeconomics that customers with inelastic demands have access to fewer substitute products" still applies today. Id. The principles of universal service embedded in the Act (see, e.g., Section 13-103(a), 13-506.1(a)) must be applied to the Commission's consideration of how to craft the regulatory plan to be adopted in this docket. When it issued the 1994 Price Cap Order, the Commission noted:

> With respect to the price/cost disparity, we agree that it is unfortunate that some disparity also will be frozen in place, but we believe that the preservation of universal service represents a matter of public interest that overrides rigid adherence to pure cost-based pricing.

[1] For purposes of this Section, "basic residence service rates" shall mean monthly recurring charges for the telecommunications carrier's lowest priced primary residence network access lines, along with any associated untimed or flat rate local usage charges.

Price Cap Order at 65-66. These observations remain as salient, if not more relevant, today as they did in 1994, according to CUB.

Third, CUB notes that AI's argument that residential rate increases would address alleged subsidies other services have provided to residential services, and would allow competition to grow vigorously in the residential market simply does not withstand scrutiny. AI Ex. 4.2 at 20-21. As noted by Mr. Dunkel's detailed study of the Company's cost of service studies, the current residential NAL rates are well above their long run service incremental cost ("LRSIC"). GCI Ex. 8.0 at 11-13. Accordingly, the alleged subsidy of residential NAL service is illusory. Second, the protection of captive ratepayers is a central mandate of alternative regulation under the statute, according to CUB. Promoting "competition" that results in higher prices for residential customers is not. Certainly, the General Assembly would have something to say in response to a Commission Order that endorsed Dr. Harris' "competition at all costs" viewpoint, CUB opines.

In its Reply Brief in this docket, AI argued that the 13-506.1(c) rate cap provision, by its terms, is triggered once, and only once, when a company first files for approval of an alternative regulation plan. AI Reply Brief at 33. AI further opines that extending a residential rate cap "would deprive the Commission of far more ratemaking authority than the legislature intended." AI Reply Brief at 33. AI argues that imposing the cap would leave the Commission unable to halt it regardless of whether it believed its extension was appropriate in light of pricing and competitive considerations.

In their Exceptions to the HEPO, GCI/City responds that AI is wrong in its interpretation of Section 13-506.1(c). GCI/City argues that in the Second District Appellate Court's review of the Commission's 1994 Price Cap Order, the Court referenced 13-506.1(c) and concluded "*any* plan adopted must maintain basic residential service rates for three years at the level in effect 180 days before the filing of the plan." Illinois Bell II, 283 Ill. App. 3d 188 at 204 (emphasis added). The General Assembly specifically chose to use the phrase "any plan", and not "the first plan" when referencing the rate cap requirement. The canon of statutory construction which provides that statutes are to be interpreted in light of their "plain meaning" dictates that the Commission impose, at a minimum, a rate cap for basic residence service rates for the first 3 years the plan approved in this docket is in effect.

GCI/City pointed out that in addition to the plain language of the statute as a reference for the General Assembly's intent when it crafted Section 13-506.1(c), the Second District Appellate Court removed any doubt about when and how often the rate cap is to be implemented when it held:

> We consider section 13-506.1(c) to be a safeguard against *any plan* promulgated in violation of the standards created by the legislature. The minimum three-year moratorium on rate increases ensures that the legislature has the time to amend or rescind any Commission action taken pursuant to section 13-506.1 This protects against any errors the Commission may make in applying section 13-506.1's standards.

Illinois Bell II, 283 Ill. App. 3d 188, 204 (emphasis added). Here, the Court made clear that it viewed this language in Section 13-506.1 to protect ratepayers from Commission errors in the implementation of *any* alternative regulatory plan adopted by the Commission, not just the first plan. Moreover, it ultimately negates the issue of whether the plan approved by the Commission is characterized as "new" or "modified".

Commission Analysis and Conclusion

When the Commission first approved alternative regulation for AI in 1994, our goal was to ensure that the conditions set forth in Section 13-506.1(b) are met, and to protect the customers whose demands are the most inelastic from the exercise of monopoly pricing power during the pendency of the plan. Those goals remain just as salient today as they were in 1994.

For instance, residential NAL and usage service (Bands A and B) remain noncompetitive services subject to negligible competitive threat. By including these services under a rate cap, and making the additional modifications to the formula set forth in this Order, "the customers whose demands are the most inelastic" will, again, "be protected from the exercise of monopoly power during the pendency of this plan." See Price Cap Order at 64. When combined with the rate reinitialization and modifications to the formula adopted herein, extension of the residential rate cap will help ensure that rates produced under the plan are "fair, just and reasonable", as required under Section 13-506.1(b)(2) of the Act.

In addition, the Commission's concern with satisfying the statutory and policy goal of universal service has not changed in the six years since the price cap plan began. Indeed, our concern with ensuring that residential service remain affordable for all customers should be heightened, given the decline in universal service Illinois has experienced during the life of the price cap plan. The Commission's recognition of the "general principle of microeconomics that customers with inelastic demands have access to fewer substitute products" still applies today. Id. The principles of universal service embedded in the Act (see, e.g., Section 13-103(a), 13-506.1(a)) must be applied to the Commission's consideration of how to craft the regulatory plan to be adopted in this docket. With these thoughts in mind, we hereby extend the statutorily required rate cap to a five-year period and include Band B usage service under the cap as well.

Third, AI's argument that residential rate increases would address alleged subsidies other services have provided to residential services, and would allow competition to grow vigorously in the residential market simply does not withstand scrutiny. As noted by Mr. Dunkel's detailed study of the Company's cost of service studies, the current residential NAL rates are well above their long run service incremental cost ("LRSIC"). Accordingly, the alleged subsidy of residential NAL service is illusory.

Also, the protection of captive ratepayers is a central mandate of alternative regulation under the statute. Promoting "competition" that results in higher prices for residential customers is not.

Finally, we must abide by the Second District Appellate Court's review of the Commission's 1994 Price Cap Order, wherein it referenced 13-506.1(c) and concluded that "*any* plan adopted must maintain basic residential service rates for three years at the level in effect 180 days before the filing of the plan." Illinois Bell II, 283 Ill. App. 3d 188 at 204 (emphasis added). The General Assembly specifically chose to use the phrase "any plan", and not "the first plan" when referencing the rate cap requirement. The canon of statutory construction which provides that statutes are to be interpreted in light of their "plain meaning" dictates that the Commission impose, at a minimum, a rate cap for basic residence service rates for the first 3 years the plan approved in this docket is in effect.

The Second District Appellate Court removed any doubt about when and how often the rate cap is to be implemented when it held:

> We consider section 13-506.1(c) to be a safeguard against *any plan* promulgated in violation of the standards created by the legislature. The minimum three-year moratorium on rate increases ensures that the legislature has the time to amend or rescind any Commission action taken pursuant to section 13-506.1 This protects against any errors the Commission may make in applying section 13-506.1's standards.

Illinois Bell II, 283 Ill. App. 3d 188, 204 (1996)(emphasis added). Here, the Court made clear that it viewed this language in Section 13-506.1 to protect ratepayers from Commission errors in the implementation of *any* alternative regulatory plan adopted by the Commission, not just the first plan. Moreover, it ultimately negates the issue of whether the plan approved by the Commission is characterized as "new" or "modified".

We adopt a residential rate cap that caps the rates for residential access and Bands A and B usage service for a five-year period after entry of this Order in accordance with section 13-506.1(c) and so that AI's most captive customers will be protected from the exercise of Ramsey pricing for the life of this plan.

D. Proposed New Component Merger Related Savings/M Factor

This Commission approved the merger of Ameritech Corporation and Southwestern Bell Corporation ("SBC"). (Merger Order Docket 98-0555). In the Merger Order the Commission ordered that AI track all merger related costs and savings. Pursuant to the Merger Order, information on merger related costs and savings are to be submitted annually with AI's annual price cap filings until an updated price cap formula is developed in 98-0252. In the Merger Order the Commission anticipated that an updated price cap formula could be developed in this proceeding that would permanently flow through 50% of net actual merger savings to customers. Further, the Merger Order required the retention of a third party auditor to develop and establish accounting standards so that the Commission could identify merger related costs and savings. In the event there are merger related savings, 50% of those saving allocable to AI are to be allocated to Illinois ratepayers.

AI's Position

AI's position is that a permanent solution to merger savings cannot be adopted yet. AI contends that the Merger Order requires that permanent rate adjustments be based on actual net merger savings, and since AI will not reach a "going level" of merger savings until the first 1/4 of 2003, it is premature to address the issue of merger savings. AI recommends that the amount of net merger related saving should be based upon the year 2002. However, since there was no consensus of the parties, AI suggests that merger saving continue to be handled in the annual price cap filing on an interim basis and that a permanent solution be deferred to another proceeding.

In its "New Components" section of it Reply Brief, Staff states that it would prefer that merger saving be handled through a one time permanent adjustment to the PCI but then states that the Commission could also calculate a "M" factor based upon merger savings as well. In the Merger Costs and Savings section of its Reply Brief, Staff again suggests that the Commission may consider two options, either make a one time adjustment to the PCI, presumably whenever a final determination of merger related savings can be obtained, or include a merger related savings factor to the price cap formula. With respect to AI's proposal that any permanent solution be based upon year 2002 data, Staff disagrees. Staff argues that AI's proposal will not capture all merger related costs and savings because by 2002 only 96% or merger related savings will be actualized. (Staff Reply Brief at 33.) Staff recommends that the terms of the merger condition remain in effect until the Commission completes its review of this modification
to the Plan. Staff suggests that this modified plan be reviewed in four years, with a final order in place before July 1st of the fifth year. (Staff Reply Brief at 32.) By 2004, Staff contends, the extent of actual merger related savings will be known and that a one-time adjustment to the price cap index could then be made.

Staff's Position

Alternatively, Staff proposes that the price cap formula be modified at this time to reflect 50% of SBC's current estimate of merger costs and savings. Staff opines that since merger costs and saving amounts have already been reviewed by SBC's upper management and analyzed by its merger integration teams, the current estimate of net merger related costs and saving has a high probability of being achieved. (Staff Reply Brief at 34.) In Staff's view, a merger costs and saving factor would reduce the regulatory burden of determining the actual amount of costs and savings on an annual basis. Although Staff did not specifically provide in its briefs exactly what it thought the M factor should be, it did provide data which it extrapolated by using data from the merger case and that which was based upon evidence provided by Staff in this docket. (Id. at 35.)

GCI/City's Position

City/GCI recommend the use of an M factor in the price cap formula. Because there is only specific data on merger saving for three months in 1999, City/GCI propose that the M factor by initially established on the basis of the level of savings that Ameritech and SBC Boards of Directors had anticipated when the "transfer ratio" value was set. Applying the 50% ratepayer allocation of savings that the Commission adopted in the Merger Order and Ameritech/SBC's anticipated level of savings, would result in a M factor of 4.8%. Finally, -City/CUB and Cook County suggest that following a review of this modification to the Plan, should the Commission determine that 4.8% M factor be too low or too high, the Commission can adjust the PCI up or down accordingly.

AI's Position

AI specifically opposes City/GCI's proposal. The Company notes that making an adjustment now based on the same estimated data presented in Docket 98-0555 would be inconsistent with the plain terms of the Order, which AI states, requires the adjustment be based on actual data. Even more importantly, AI contends is that Dr. Selwyn's approach to calculating these savings on an estimated basis produced vastly excessive savings amounts in Docket

98-0555. The same problem exists in this docket, since GCI is relying on precisely the same analysis. Since the Commission rejected Dr. Selwyn's approach in Docket 98-0555, AI argues that there is no basis for adopting it here. (Merger Order at 147.)

Commission Analysis and Conclusion

The Commission concludes that GCI's proposal should be adopted. While in Docket 98-0555 we indicated that merger savings adjustments would not be based on the estimates but rather actual merger related savings, it has become clear that this method is less than ideal. The approach suggested by GCI allows merger savings to be flowed through to ratepayers in a timely fashion and is adopted. Further, while initially based on estimates, the M factor in the formula can be adjusted up or down as appropriate.

The Commission concludes that adopting an "M" factor in this docket is consistent with the Merger Order and the most expeditious approach to merger savings. In the Merger Order we said that net merger savings are to be allocated to consumers using an interim methodology until the appropriate mechanisms are made in the five-year review of the Plan. Merger Order at 146. Deferring merger savings until all audits are complete will result in unacceptable regulatory delay and expense. As the complexity of the merger savings audit has become apparent in ICC Dockets 00-0260 and 01-0128, the Commission finds the need to pass these savings on to consumers in a timely and predictable manner more compelling.

Dr. Sewlyn's approach, which provides consumers with the benefits of the merger savings subject to subsequent review, addresses our concerns about both insuring timely reflection of savings in rates, and the need to provide consumers with actual, rather than projected, savings. Dr. Selwyn uses the savings figures relied upon by SBC in agreeing to purchase Ameritech, and these savings amounts represent a reasonable approximation of merger savings pending review of an audit. Further, use of the "M" factor provides an appropriate incentive to all parties to address issues promptly.

E. Baskets

1. Generally

Under the terms of the original Plan, non-competitive services were divided into four baskets. The four baskets consisted of the following: 1) the Residential basket contained access and Band A, Band B, and Band C usage; 2) the Business basket consisted of business access, Band A through D usage, and certain discretionary services; 3) the Carrier basket consisted of switched access, special access, cellular access and other various carrier services; 4) the Other Services basket contained directory services, directory assistance, operator services, payphones, private lines, discretionary residential services and name and address service in Chicago. Alt Reg Order at 66 and 69. The baskets were structured to ensure that all customer classes benefited equally from price regulation, and, with respect to the splitting of residence services between the Residential and Other baskets, to facilitate the application of the five-year rate cap on basic network access lines and usage. (Alt Reg Order at 68-69.)

The four basket system has been maintained throughout the life of the Plan, although the makeup of each basket has changed. As provided for in the Plan, AI may withdraw services from baskets by reclassifying them as competitive. Since the Plan became effective, and including those reclassifications currently under investigation in Docket 98-0860, Staff claims that revenues subject to the Plan, i.e. from services within the four baskets, have declined by $350 million. In particular, Staff asserts revenues from the Business basket have declined by 94%.

2. Proposed Modifications to the Basket Structure

a. Consolidation of Baskets

AI's Position

On a going forward basis, AI proposes that all services which remain under the Plan be consolidated into a single basket. Because many services within the Business and Carrier baskets have been reclassified as competitive and/or because many carrier services are now priced on an incremental cost standard, AI suggests that there is no longer a need for multiple baskets. AI contends there is a benefit to a single basket system. AI asserts that a single basket would allow greater flexibility in structuring discounted service packages for customers and permit a meaningful opportunity to restructure rates across customer classes. Alternatively, AI proposes that all residential related services be combined into one basket.

Staff's Position

Staff contends that the four basket system should be maintained. Generally, Staff objects to AI's single basket proposal because of its concern with customer class discrimination. "[C]ustomer class discrimination occurs when a specific class does not receive the rate reduction given to other classes. To avoid such discrimination, the Commission placed residential, business and carrier services in separate baskets. Therefore, when rate reductions are required in an annual filing, each customer class receives similar benefits. Any combining of service baskets eliminates the protection that certain customers currently receive." (Staff Reply Brief at 25.)

Despite what Staff views as the premature reclassification of certain business services by AI, Staff maintains that the need for the four basket system remains. Even if AI's business reclassifications are not found to be improper in Docket 98-0860, Staff contends that the need for a separate Business basket continues given the potential for new business services which could cause a basket to expand significantly. Given that access charges are non-competitive services Staff argues that the Carrier basket should remain. Further, Staff claims that the Residential basket must continue as competition does not exist in any meaningful sense for those services.

GCI/City's Position

GCI/City also objects to AI's modified basket structure proposal. This would undermine the plan's compliance with section 13-506.1(b)(7) which requires that the plan "will not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunications carriers." In light of IBT's expressed intent to raise residential network access line charges given the opportunity, consolidation of the baskets into one or the consolidation of the residence and the "other" basket would almost certainly lead to Ramsey pricing, and customers of POTS would receive virtually no benefit from the alternative regulation plan despite cost reductions. GCI/City arguments as why the four basket structure should remain mirror those made by Staff.

AT&T's Position

AT&T agrees with Staff and GCI/City that on a going forward basis, the four basket system be used. Further AT&T maintains that AI's rationale for co-mingling all the baskets into one has been undermined by the Hearing Examiners' Proposed Order in Docket 98-0860, wherein the Hearing Examiners concluded that AI had prematurely classified all the business services under investigation in that docket. Procedurally, AT&T notes that should the Commission accept the findings and conclusions in the HEPO, all those services under investigation previously reclassified as competitive, would be returned to the Business basket. On a more general basis, AT&T takes issue with the proposition that unless a basket contains several services, it should be eliminated. Even, if the services at issue in 98-0860 were found to be competitive at the time of reclassification, AT&T argues that it is conceivable that in a developing market, new business services would be created and therefore need a home in the Business basket. .

Further, AT&T asserts that the premise of the four basket structure was to ensure that all customer classes were treated equitably, free from discrimination and cross subsidies. (AT&T Reply Brief at 6.) AT&T sets forth the statutory underpinnings behind the four basket system. Pursuant to the Act, no alternative regulation plan may be adopted which would unduly or unreasonably prejudice or disadvantage any particular customer class. AT&T Reply Brief at 5 citing 220 ILCS 5/13-506.1(b)(7). AT&T quotes from AI's Initial Brief wherein AI stated "[t]he [four] basket structure and residential rate protection functioned precisely as the Commission intended. All rate reductions required by the Plan were flowed through equitably to each customer group." (Id. at 6, citing AI Initial

Brief at 30.) AT&T concludes that the four basket structure is a tried and true mechanism to ensure that all customer classes are protected and treated equitably.

b. Calling Plans and New Services

During the Plan, AI introduced several residential calling plans, which offered different usage rates for bands A, B and C calls. Bands A and B are residential non-competitive services, and were included in the Residence basket at the inception of the Plan. AI priced these calling plans as "new services" and as a result the price changes were not subject to the price cap index. One year after the new rates were established, AI returned the calling plans to the Plan in the Other basket at their calling plan rate.

Staff's and GCI/City's Position

Staff and GCI/City propose that residential calling plans be transferred from the Other basket to the Residential basket. In their opinion, calling plans change the price for residential Bands A and B calls, and therefore belong in the Residential basket. They argue that these services are not truly discretionary as no customer could make use of the network without obtaining these services, and Bands A and B usage were placed in the Residence basket in the original Alt Reg Order. Additionally, they argue that placing calling plans in the Other basket enables the Company to circumvent the price cap index and renders the price cap plan less effective at ensuring that benefits are passed on to the most captive customer.

GCI/City argue that to avoid this manipulation of the Plan, new services should be defined by the Commission to exclude services subject to the price cap. Repricing non-competitive, price cap services or bundling them with competitive services does not make them "new services" and should not remove them from the protections of the price cap index. Each repackaged price cap service should be kept in the same service basket it was in prior to the repackaging, and subject to the price cap mechanism for that basket. Only services not previously offered by the Company should be treated as new services under the plan. They point out that more than 90% of the new services revenues are from these Band A and B calling plans showing how few new services AI has offered, and how AI has abused the new services provision of the Plan. They add that the Plan was designed to regulate AI through its pricing, and if price changes were enough to remove a non-competitive service from the Plan, the constraints of the Plan would be easily avoided.

AI's Response

AI opposes Staff and GCI/City's proposal to move calling plans from the Other basket and into the Residential basket. Under the Plan, AI explains, new services are excluded for one year and new residential services are then placed in the Other basket, together with other optional residential services. AI views calling plans as an optional service as they offer customers choices they previously did not have. AI contends its interpretation of calling plans as an optional service is consistent with the FCC definition of a new service under its price cap plan. Finally, AI suggests that its view is consistent with that of the Commission's in that the Residential basket was intended for basic services while the Other basket was intended for discretionary services.

GCI/City responded that the FCC's definition of new services consists of two parts, neither of which AI's calling plans comply with. Specifically, GCI witness Charlotte TerKeurst described the two prongs of the FCC definition as: (1) the new service must provide for a class or subclass of service not previously offered, and (2) the new service must enlarge the range of service options available to ratepayers. GCI Ex. 11.0 at 61. GCI/City maintain that repackaging existing services meets neither prong of this definition.

c. Elimination of Certain Services from Baskets

AI's Position

AI recommends that 911 services, UNEs, wholesale and carrier access charges be excluded from the operation of the index, i.e. excluded from the basket structure. AI asserts that by previous Commission order, 911 services and UNEs have been excluded from the Plan. (AI Initial Brief at 46, citing Order and 96-0486/0569.)

AI argues that because the Telecommunications Act of 1996, “TA96,” (***Cite) requires that UNE prices must be set at TELRIC, plus an appropriate allocation of common overhead costs, it remains appropriate to exclude UNE services from the basket structure. With respect to wholesale services, AI argues these services should be treated similarly to UNEs, because, pursuant to TA96, wholesale services must also be priced based upon a cost standard. AI contends that it is entitled to set its wholesale rates based on a costs standard and TA96 does not contemplate any further reductions. (Id at 47.) AI makes a similar argument with respect to switched carrier access rates. Because the Commission requires switched carrier access rates to be set at LRSIC plus common overhead allocation, further potential decreases inflicted by the basket structure would be impermissible. AI asserts that further downward adjustments based on the price index would result in carrier access rates which are below the level which the Commission has already found to be reasonable and equitable. (i.e. LRSIC plus common overhead allocation.)

Consequently, AI proposes those services which the Commission has previously excluded from the basket structure continue to be excluded, and wholesale and carrier access charges be excluded on a going forward basis. Finally, AI contends that the cost changes reflected in the X factor do not translate into changes in LRSIC/TELRIC costs or common costs since the X factor reflects changes in actual operating costs while LRSIC and TELRIC already assume the use of forward looking technologies and operating practices. According to AI, applying the X factor to carrier access charges or UNEs would improperly double count productivity gains.

GCI/City’s Position

GCI/City reject AI’s proposal to eliminate UNEs, wholesale services and carrier rates from the price cap. GCI/City reject the premise that their exclusion is justified because they are based on LRSIC and TELRIC studies, noting that these rates contain a contribution towards common overhead costs. They emphasize that common overhead costs are exactly the costs that would be reduced as a result of general productivity and costs savings measures.

GCI/City witness TerKeurst refutes AI’s claim that including UNE, wholesale service and carrier rate in the price cap will result in double counting of productivity gains. She claims that there is no evidence to support that AI has accurately predicted every change, including technology changes, input levels and input mixes that will occur for these services.

AT&T’s Position

AT&T also addresses the issue of the make-up of certain baskets. First, with respect to the Carrier basket, AT&T proposes that UNEs, Interconnection and Transport, and Termination services should be added and that carrier access services should remain therein. AT&T contends that continuing to include carrier access services in the price cap mechanism is consistent with forward looking cost based pricing of switched access services. AT&T posits that including carrier access services in the price cap mechanism will ensure that switched access rates properly reflect cost reductions as AI’s cost of providing access services declines over time.

AT&T contends AI’s arguments regarding why certain services should be excluded from the alternative regulation plan are at best abbreviated. AI’s stated rationale for excluding UNEs from the price cap mechanism is that the Commission excluded UNEs from the Plan in its Order in 96-0486/0569 because the federal Act requires that UNEs be set at TELRIC plus an appropriate allocation of shared and common costs. AT&T states that although the Commission in its Order in Dockets 96-0486/0569 declined to include UNEs, interconnection, termination, and transport services in the Plan, it did so with the caveat, “at the present time.” AT&T argues that the language “at the present time” used by the Commission means that the Commission is free to reconsider the issue. AT&T asserts now is the time to revisit the issue.

AT&T contends that the reasons the Commission found for excluding UNEs from the Plan are no longer in existence. One reason to no longer exclude such services is the extremely generous shared and common cost markup AI is allowed to assess to UNEs. Further AT&T asserts, customers do not have competitive alternatives for UNEs; hence, UNEs are appropriately classified as noncompetitive. With respect to AI's contention that UNE prices must be set at TELRIC plus common overhead costs, AT&T argues that the rates adopted by the Commission in the TELRIC Order are not price floors but rather price ceilings. Because the price cap formula is designed to capture AI's efficiency gains, AT&T asserts there is no reason that AI's efficiency gains should not also flow to the UNEs, interconnection and transport and termination services. AT&T argues that the Commission should not deprive CLECs and their customers of these efficiencies. AT&T concludes that UNEs should be included in the Carrier basket.

With respect to carrier access services, AT&T contends that AI misstates the Commissions order in 97-0601/0602 ("Phase II Order") in support of its position to exclude carrier access services from the price cap formula. AT&T Reply Brief at 14. AT&T contends that the Commission did not set AI's carrier access rates *at* LRSIC plus common overhead allocation, but rather the Commission required AI to set carrier access rates at LRSIC, and then gave AI the right to include in its carrier access rate an allocation of shared and common costs not to exceed but be capped at 28.%. (Id at 15.) AT&T supplied the following quote from the Phase II Order:

> Accordingly, we adopt the shared and common cost percentages for switched access rate elements contained in AT&T Gebhardt Cross Ex. 1A, page 3, and conclude *that the maximum shared and common cost contribution shall be 28.86%* for both Ameritech's and GTE's cost-based switched access rate elements. Order dated March 29, 2000, ICC Docket Nos. 97-0601/0602, p. 51 (emphasis supplied).

AT&T asserts that operative word in the quote above is "maximum." Staff witness Koch also agreed that the Phase II Order does not *set* the shared and common cost allocation *at* 28.86% but, rather, *caps* the shared and common cost allocation.

AT&T counters AI's assertion that any reductions to its LRSIC costs and common overhead allocations for carrier access services can be reflected via updated cost studies. AT&T points to GCI witness TerKeurst's testimony wherein she stated that it took almost three years to litigate dockets 97-0601/0602. AT&T's point is that the delay associated with 97-0601/0602 demonstrates that the process of investigating and litigating AI's cost studies is almost inevitably a lengthy, contentious and resource intensive process for both the Commission and the interested parties. As such, AT&T suggests the process of reviewing or updated AI's costs studies are not as simple or expeditious as AI contends.

AT&T agrees with CUB in that price cap provisions could provide a convenient, low cost and routine approach to updating rates derived initially through cost studies, thus avoiding or deferring lengthy and contentious proceedings to evaluate cost studies and update rates for these services, and furthering the goal of reducing regulatory costs. (AT&T Reply Brief at 15, citing CUB Initial Br. at 67.)

AT&T also agrees with GCI witness Terkeurst relative to what it views as AI's inability to accurately predict future changes in operating costs in LRSIC/TELRIC calculations. AT&T's asserts that application of the PCI to carrier access charges will not result in double counting of costs. AT&T therefore concludes that such services should be included within the Carrier basket and customers purchasing those services should receive the benefits of the price cap mechanism. (AT&T Reply Brief at 7.)

AT&T argues that wholesale services should continue to be included within the Plan. While AI contends that nothing in TA96 contemplates further reductions, AT&T posits that nothing in the federal Act precludes further reductions to wholesale rates. AT&T notes that AI itself concedes that wholesale rates must decline with their retail counterparts. Thus AT&T concludes, to the extent AI experiences cost reductions, wholesale services should also benefit from those reductions through the price cap mechanism. AT&T Reply Brief at 13-14. Moreover, AT&T explains, wholesale services have been included in the alternative regulation plan for almost six years since the Commission adopted its Wholesale Order. AT&T contends the Commission should continue to include wholesale services within the alternative regulation plan for the same reasons carrier access charges and UNEs should be included.

AT&T proposes a further modification with respect to wholesale services. AT&T recognizes that although wholesale services being provided by AI are in fact carrier services, it is more appropriate that said services follow their retail companion. Finally, AT&T notes that where a wholesale service is included within the same basket as the corresponding retail service, the same consumer classes will be addressed independent of their customer classes. This, AT&T concludes, will allow customer classes to be treated equitably and free from discrimination and cross subsidies.

Commission Analysis and Conclusion

The Commission concludes that the current four basket structure should be continued on a going forward basis. AI's arguments for a modification are not persuasive. Since the opening of Docket 98-0860, AI returned all the residential services which were previously reclassified as competitive to a non-competitive status. Serious questions have been raised as to the propriety of the business services AI reclassified as competitive. Under the Plan, provisions were made allowing for services to be returned to a noncompetitive status as well as new services being added to baskets. The elimination or consolidation as proposed by AI does not further the goals of protecting a customer class. The Commission finds that a four basket structure continues to ensure that all customer classes are treated equitably, free from discrimination and cross subsidies.

We further conclude that AI has improperly treated residential calling plans as new services and has improperly assigned them to the "Other" basket. Calling plans that simply reprice existing services should be subject to the price cap index. Otherwise, the efficacy of the price cap index can be seriously compromised. We expressly hold that the mechanisms currently in place for new services and how they are to be treated within the PCI apply only to services that are not now subject to the price cap index. Repricing must take place within the price cap index for non-competitive services.

We conclude that 911 services should be included in the price cap index. 911 services have essentially been set at cost to promote public safety objectives and as costs decrease it is reasonable to pass those cost decreases to municipalities and other public entitles.

With respect to UNEs, wholesale and carrier access charges, the Commission concludes said items shall not be excluded from the operation of the index and shall be included within the basket structure. UNEs shall be made apart of the Carrier basket. Wholesale rates shall remain apart of the Carrier basket. Carrier Access Services shall remain in the Carrier basket.

Ultimately, we are persuaded by the positions of AT&T and City/CUB with respect to the inclusion of UNEs, wholesale services and carrier access rates within the price cap mechanism. Our conclusion relative to these issues is uniform and consistent.

Though we had previously withheld application of the price cap mechanism to UNEs in the TELRIC Order, we agree that now is the appropriate time to reassess our position. AI is the beneficiary of generous shared and common cost markups which AI is allowed to assess to UNEs. Further, customers do not have competitive alternatives for UNEs and therefore UNEs are appropriately classified as noncompetitive. For these reasons we conclude that it is appropriate to reassess whether to include UNEs within the price cap mechanism.

With respect to UNEs, the rates adopted by the Commission in the TELRIC Order shall be considered as price ceilings and not as price floors. As with UNEs, the carrier access rates adopted by the Commission in the Phase II Order should be considered as a price ceiling and not as a price floor. The text of the order cited above by AT&T clearly states the intention of the Commission in this regard. AI's interpretation is flawed.

We are similarly persuaded to continue to include wholesale rates within the price cap mechanism. Our Wholesale Order does apply an avoided costs standard, similar in effect to those costs standards imposed upon UNEs and carrier access rates. However, we note that there is nothing within the federal Act to preclude further reductions to wholesale rates. We agree with AT&T that to the extent AI experiences cost reduction, wholesale services also benefit from those reduction by operation of the price cap mechanism.

d. Reinitialization of API & PCI

The PCI, or price cap index, is the number derived from the price cap formula. It represents the cumulative change in inflation, the X factor, the service quality factor and any exogenous factors. Every year the PCI is recalculated, and the resulting number determines the percentage change to be made to the rates in the four service baskets established under the Plan. See generally Alt. Reg. Order at 20. The API, or adjusted price index, applies to each service basket and represents the cumulative rate change in that service basket. The API should be less than or equal to the PCI in any given year. Alt. Reg. Order, App. A at 3.

In our Order, the Commission set both the API and PCI equal to 100 (Order at Appendix A.), Section 2(a). Staff and GCI/City recommend that these indices, which have declined over time, be reset to 100 on a going forward basis. According to Staff, reinitialization will have the effect of affording the Plan the maximum capacity to affect rate changes. Staff acknowledges that reinitialization will primarily affect the Carrier Basket. Similarly GCI/City, state that absent reinitialization, customers purchasing services from the Carrier basket, such as switched access services and unbundled network element ("UNEs") (assuming that carrier access and other carrier services are included in the basket as GCI/City recommend), would not benefit from efficiency gains experienced by AI in the future. Said customers would receive no benefit because the API for the Carrier Basket is already well below the PCI. Further GCI/City contend that any rate adjustments resulting from an overall review of AI's earnings in this docket must be reflected in a reduced API/PCI.

AI opposes the reinitialization of the API/PCI indices. By reinitializing, AI argues, "headroom" is effectively eliminated. Headroom occurs when rates in particular baskets decline more than the index would have required. Reinitializing the API/PCI combined with subjecting carrier access rates to the price index, would, AI contends, require further decreases to carrier access rates in the annual price cap filing. (Ameritech Reply Brief at 38.) This result, AI concludes, is inconsistent with the Commission's Order in Docket 97-0601/602. (Id.)

Further, AI states, there is little likelihood it could offset the headroom associated with carrier access rate decreases with increases in other carrier rates. AI notes that other services within the Carrier basket are incapable of being increased as they would require another TELRIC/wholesale(resale) pricing proceeding. Additionally, AI states that it had not made any changes to the basket since it developed its headroom in 1997.

Commission Analysis and Conclusion

The Commission concludes that the API/PCIs in the existing Plan should be reinitialized on a going forward basis. The 1994 Plan has expired, and the Plan approved in this docket is a new Plan, based on a different record. The efficacy of the new Plan will be serverely compromised if the API were not reset to 100 at the outset of the Plan. We realized that reinitialization of the API and PCI will effectively eliminate the "headroom" which currently exists, but note that it was created by our orders setting UNE and carrier rates. Those rates were meant to be cielings, and if the "headroom" resulting from those rate decreases is not eliminated, we will not be able to expect those rates to decrease as a result of the price cap index regardless of whether they are included in the Plan or not.

F. Earnings Sharing

GCI/City's Position

GCI/City propose that the Commission add an earnings sharing component to the Plan on a going-forward basis. GCI/City note that, in approving a pure price cap form of regulation, the Commission stated that it would reconsider the evidence and policy considerations for earnings sharing in future review proceedings. (Order at p. 51.) GCI/City argue that the evidence in this docket demonstrates that AI's earnings have been excessive under the existing plan, and that ratepayers have received no benefit from these excess earnings. GCI/City assert that the high earnings experienced by AI could be the result of an incorrectly set price cap index, unexpected economic conditions, improper exercise of market power, improperly classified services and irresponsible or poorly managed service performance. In GCI/City's view, earnings sharing can "balance risks, incentives and rewards in the overall regulatory mechanism" and provide consumers with some protection from unexpected results. GCI/City also contend that earnings sharing lessens AI's incentives to increase earnings by sacrificing service quality or improperly reclassifying services as competitive because its actions are still subject to some review and it does not keep all of the benefits of alternative regulation, but shares them with consumers.

GCI/City recommend the following parameters of an earnings sharing provision:

A benchmark rate of return would be set 200 basis points above the adopted weighted average cost of capital for AI;

A cap on AI's rate of return would be set at 600 basis points above the adopted cost of capital, thereby creating an absolute after-sharing limit on AI's rate of return;

_ Any earnings between the benchmark and cap rates of return would be shared on a 50/50 basis between shareholders and ratepayers and any earnings above the cap rate of return would be returned entirely to customers;

_ Revenues from all services that would be included in a revenue requirement determination under cost-of-service regulation would be included in the revenue sharing calculation, except that services for which the Commission has found that AI does not retain significant market power could be excluded if all related expenses and investments were also excluded;

_ The customer's portion of any shared earnings would be distributed as a one-time credit on their bills during one or more months in the following year; and

_ The earnings sharing provision would require an adjustment for the year during which the prior year's earnings above the benchmark are distributed to customers, to prevent the shared earnings from incorrectly depressing current year earnings.

AI's Position

AI opposes adoption of an earnings sharing provision. AI contends that earnings sharing brings with it all of the issues and baggage associated with rate of return regulation: debate over depreciation rates; extensive reporting and monitoring of AI's investments, rate base and profitability; prudence reviews; and continuing debates over the level of profits AI's earning and how much it should be allowed to keep. Thus, AI argues that earnings sharing does not break the link between AI's cost and rates. AI views divorcing costs/earnings from rate as a critical component in price regulation. AI further contends that earnings sharing would result in higher, not lower, regulatory costs and delay.

AI also argues that earnings sharing plans blunt the efficiency incentives of price regulation. Once the 50% sharing threshold has been reached, efficiency incentives are reduced dramatically and they are eliminated altogether once the cap is reached. Moreover, because GCI's accounting adjustments flow through in rate reductions the equivalent of 1,311 basis point in earned return, AI asserts that it would be required to share before its actual earnings ever reached a reasonable level. Thus, AI contends, many of the most important behavioral benefits of price regulation will be lost.

AI further argues that earnings sharing is fundamentally inconsistent with the Commission's decision in 1994 to allow AI to assume responsibility for capital recovery. AI states that the debate over depreciation expense in this proceeding clearly demonstrates why depreciation freedom and earnings regulation are incompatible. Moreover, AI notes that GCI/City propose that whatever decision the Commission makes on depreciation issues in this case would be frozen for the next five years to calculate sharable earnings, absent another Commission proceeding. Thus, if the Commission adopts GCI/City's earnings sharing proposal, AI argues that the Commission will de facto be back in the business of prescribing AI's depreciation rates. Consequently, AI opines, the Commission is no better able to fulfill its side of the regulatory bargain now – (i.e., to ensure full capital recovery of long-lived plant through prices over the next 20-30 years -- than it was in 1994.) AI contends this is the policy dilemma which the Commission found unacceptable in 1994 and AI states that GCI/City had proposed no solution.

AI opposes GCI/City's view that earnings sharing is a "safety net" in the event the index is misspecified or as a means of controlling for the impact of economic conditions. AI argues that the Commission has now had five years of experience with the key financial components of the index. AI argues the index was not misspecified in 1994 and there is no reason to believe it will be misspecified on a going-forward basis. AI further contends that the impact of economic conditions is something that the Commission should not attempt to control. If the economy is healthy and there is strong demand for AI's services, then AI will benefit. If the economy weakens and demand for AI's services falls off, then AI will suffer. As long as the relationship is symmetrical, AI contends, the Plan is appropriate and there is no problem which needs to be "fixed". AI further disputes GCI/City's claim that earnings sharing is necessary because the AI's earnings levels prove that the annual rate reductions under the index have been "grossly insufficient". AI argues that the X factor was, if anything, too high and that this evidence is undisputed in the record.

AI also disputes GCI/City's claim that earnings sharing would lessen AI's incentives to inflate earnings through cost-cutting measures that harm customers, such as service quality. AI notes that there is no evidence in this record that AI intentionally cut costs associated with the provision of service to inflate its earnings. AI contends the loss of installation and maintenance personnel in 1999 had nothing to do with any of its initiatives. Moreover, AI points out that there is no economic evidence to support the theory that either earnings sharing or rate of return regulation lead to higher quality service. AI argued that, in fact, earnings sharing would make it more difficult to respond to and correct service problems when they do arise.

Furthermore, AI contends that it is legally improper to apply earnings sharing to both competitive and noncompetitive services. Section 13-506.1, by its terms, is limited to noncompetitive services. In AI's view therefore, only earnings on noncompetitive services can be shared. In order to calculate earnings on noncompetitive services, the Commission would have to accept a cost allocation methodology comparable to what AI presented. Furthermore, AI points out that noncompetitive services today are earning well below any reasonable view of AI's cost of capital and that it is highly unlikely that these earnings would increase to a level where GCI's earnings sharing benchmark would ever be triggered. Under these circumstances, AI argues that the administrative costs associated with monitoring earnings and performing the requisite allocations between competitive and noncompetitive services cannot be justified.

Finally, AI contends that the time for earnings sharing had already come and gone by 1994. Many regulators in the late 1980's and early 1990's viewed earnings sharing as a comfortable transitional mechanism between rate of return regulation and pure price regulation when price regulation was new and was perceived to be risky. However, AI argues that that period has long since passed. The Company points out that even regulators who adopted earnings sharing early on – (e.g., the California PUC and the FCC), on whose plans Ms. TerKeurst modeled her proposal -- have since moved on to pure price regulation.

Staff's Position

Staff also opposes adoption of earnings sharing. According to Staff, earnings sharing represents double regulation. Adding an earnings sharing component to price cap regulation would mean that both AI's prices and earnings would be regulated. Moreover, Staff agrees that earnings sharing would bring with it all the problems associated with rate of return regulation. Further, Staff contends that earnings sharing is impossible to implement in any meaningful fashion when some services are subject to competition while others are not. In Staff's view, imposing earnings sharing on the entire company would mean that subscribers of noncompetitive services would inappropriately share the risks and rewards of AI's management decisions in the competitive area. Staff takes the position that noncompetitive service customers are fully protected by the index and that problems stemming from competitive classifications should be addressed directly, not through the adoption of earnings sharing.

Commission Analysis and Conclusion

The Commission concludes that GCI/City's earnings sharing proposal should not be adopted. Earnings sharing was reviewed at length in 1994 at which time we concluded that it was not an appropriate component of the Plan. GCI's proposal in this proceeding is identical to what was recommended by Staff in 1994. We find that earnings sharing presents all of the same problems now that it did in 1994. Fundamentally, earnings sharing prevents the Commission from delinking AI's cost and rates and continues too many of the negative aspects of rate of return regulation. As a result, earnings sharing compromises the Commission's core regulatory objectives relative to this Plan and will not be adopted.

G. Monitoring and Reporting

Section 13-506.1(d) of the Act provides, in relevant part, that:

> Any alternative form of regulation granted for a multi-year period under this Section shall provide for annual or more frequent reporting to the Commission to document that the requirements of the plan are being properly implemented.

Staff and GCI/City's Position

Staff and GCI/City contend that pursuant to statute monitoring and reporting requirements must remain if the Commission is to extend AI's alternative regulation plan. The information supplied by AI through the monitoring and reporting requirements is valuable to the Commission, the Staff and the public in determining whether Ameritech is complying with the conditions of the Alternative Regulation Plan. (Staff Ex. 4 at 10-11.)

Staff asserts that reporting requirements are intended to "document that the requirements of the plan are being properly implemented. Therefore, every requirement or condition of the alternative regulation plan should be addressed in these reports." (Staff Ex. 4 at 10.) Without reporting and monitoring requirements, Staff and GCI/City argue the Commission, its Staff, and the other parties with a legitimate interest in whether Ameritech is complying with its obligations under the plan would be unable to make an informed assessment.

Further, Staff and GCI/City assert, the individual reporting requirements continue to be meaningful in a regulatory sense. In light of the Commission's ongoing authority to rescind alternative regulation plans which are failing to satisfy the statutory requirements for such plans, see, 220 ILCS 5/13-506.1(e), AI cannot assert that it should not be required to produce basic financial information especially, if the information is not available from other sources. (Staff Ex. 4 at 17.) Lastly, Staff and GCI/City argue that while it is true that Ameritech files some information in price cap filings, it is also true that there should be a single complete source of information regarding Ameritech's performance under the plan, which the price cap filings are not.

Annual monitoring and reporting requirements were imposed on AI by the 1994 Order and are fully set forth below:

1. Total Company and Illinois jurisdictional rate base for the preceding calendar year adjusted to reflect regulatory treatment ordered in Dockets 92-0448/93-0239.

1. Total Company and Illinois jurisdictional operating revenue and expenses for the preceding calendar year adjusted to reflect the regulatory treatment ordered in Dockets 92-0448/94-0239.

1. Other income and deductions, interest charges, and extraordinary items for the preceding year (with explanations);

1. Preceding calendar end of year capital structure;

1. Calculated total Company and Illinois jurisdiction return on net utility rate base and total Company return on common equity;

1. Statement of Sources and Applications of Funds for the preceding calendar year;

1. Description of proposed projects and amounts to be invested in new technology (regarding the Company's $3 billion infrastructure investment) for the current calendar year and a comparison with the actual projects and amounts invested in new technologies during the preceding calendar year;

1. Calculation of the current price cap index and actual price indexes including the formulas used, the inflation factor and its source, the general adjustment factor, the exogenous factor and a description of its calculation, and the service quality component and a description of its calculation;

1. A description of new services offered in the preceding calendar year, including the price of each and its effect on the calculation of API;

1. Demand growth by revenue basket in the preceding calendar year;

1. Summary of price changes initiated under the Alternative Regulatory Plan in the preceding calendar year;

1. A demonstration that Section 13-507 of the Act has been complied with during the preceding calendar year;

1. A summary report on Ameritech's quality of service during the preceding calendar year; and

1. A summary report on the exogenous events that affected the exogenous factor of the price cap index formula.

(Alternative Regulation Order, Appendix A at 7-10.)

AI's Position

AI contends that these existing requirements could be streamlined on a going-forward basis to reduce the costs of regulation, without any loss in appropriate Commission oversight capabilities. Specifically AI objects to the form of the Infrastructure report and states that it need not be retained if the infrastructure investment commitment is not retained.

First, AI proposes items 1-6, which are earnings-related in nature, be eliminated because they are not appropriate in a price regulation plan. AI notes that the Commission's stated rationale in 1994 for requiring this information was that high earnings could provide an "early warning" that the productivity offset may have been misspecified. In practice, however, the AI asserts that the productivity offset was not misspecified and that there is no reason to believe that it will be misspecified going forward. Second, AI submits an annual report on March 31 of each year which details it's financial performance over the preceding calendar year sufficiently sets forth other information previously required. AI contends that items 8-11 and 13-14 are unnecessary because those items are addressed in the annual price cap filings.

Finally, the 1994 Order requires an annual demonstration that AI has been in compliance with Section 13-507 of the Act and the Aggregate Revenue Test during the preceding year. AI states that it had no objection to continuation of this reporting requirement, if the Commission found it useful.

AI also recommends that the Commission not establish another predetermined, formal review proceeding in its Order in this proceeding. AI points out that the Commission provided for this current review in large part because it had had no prior experience with price regulation prior to 1994; and, even on a national level, pure price regulation plans (i.e., plans without earnings sharing) were relatively new. The Company argues that price regulation is now the rule, rather than the exception; that this proceeding provides ample opportunity to fine-tune any components of the Plan which did not meet the Commission's expectations; and that, given the time and resources which this proceeding has consumed, there should only be a second review proceeding if it proves to be necessary. AI argues that Section 13-506.1(e) provides the Commission and all parties ample authority to initiate or request an investigation if the Plan does not appear to be functioning properly in the future or if there are unexpected marketplace or economic developments. However, to facilitate the Commission's monitoring of the two key financial components of the index (i.e., GDPPI and the X factor), AI agrees to provide updated information and/or studies relative to these factors in 2007, at the time AI submits its annual price cap filing for 2006, at which point the Plan would have been in effect for another five-year period.

Commission Analysis and Conclusion

The Commission concludes that the reporting requirements associated with this Plan should be retained. The Commission, Staff and other parties have a legitimate interest in determining whether AI is complying with its obligations under the Act. The information supplied by AI through the monitoring and reporting requirements is a critical tool for determining whether AI is complying with the conditions of the Alternative Regulation Plan. We acknowledge that in certain limited instances, reporting requirements may be duplicative. While we agree with AI that one of the statutory goals of alternative regulation is to reduce regulatory costs where practicable, we are persuaded by Staff's position that there should be a single complete source of information regarding Ameritech's performance under the plan.

H. One-Time Credits or Refunds

Staff's Position

Staff proposes two one-time credits or refunds be required as part of the Commission's final Order in this proceeding. First, Staff contends that a credit or refund is required to correct AI's use of an improper definition of irregular service installation. Staff objects to the inclusion of orders for vertical services in AI's reports relative to installation within five days, and contends that these reports should be limited to network access lines. Staff suggests that, because it disagreed with the manner in which AI has defined Installation Within Five Days, AI should retroactively be found to have missed that benchmark during previous years. As a result, Staff argues that the Commission should reduce AI's rates by $29.5 million. Second, Staff argues that $7.4 million should be flowed back to customers to correct for the improper re-classification of certain residential services as competitive, a classification which AI voluntarily withdrew in February of this year. Staff also argues that approximately $74 million should be flowed back to customers to correct for the improper re-classification of certain business services as competitive

AI's Response

AI opposed both refund proposals. With respect to Installation Within Five Days, AI contends that Staff's proposal is unreasonable because the Company has always reported its installation data including all new ("N"), transfer ("T") and change ("C") orders. Vertical service orders have generally been categorized as C orders. The Company pointed out that there is nothing inherently incorrect about this definition; in fact, it is the definition suggested by the language of a recent NARUC white paper on service quality measures. Even more importantly, AI argues that this is the way AI reported the data upon which the current Plan benchmark is based. Thus, had AI reported installation performance in the manner suggested by Staff, the benchmark would not be 95.44%. AI disputes Staff's and GCI/City's suggestion that vertical service orders would have been negligible during the benchmark years of 1990-91 as not supported by the record. AI contends that the vast majority of its vertical services were introduced between 1974 and 1989, which suggests that vertical service orders were likely quite significant by 1990.

AI also argues that Staff's proposal would be unlawful. The Commission has reviewed and approved each of AI's annual rate filings under the Plan, including the service quality adjustments in the Plan's PCI calculations. AI contends that to impose a rate adjustment now, based upon Staff's current view of the manner in which installation data should have been (but were not) reported in the past, would be fraught with both legal and policy implications, including violation of the prohibition against retroactive ratemaking. Since AI's rates were previously lawfully approved by the Commission, AI argues that to require a refund now would be unlawful. Independent Voters of Illinois v. Commerce Commission, 117 Ill. 2d 90, 95-98 (1987).

AI also opposes a refund/credit associated with the reclassification of certain residential services and business services which are the subject of Docket 98-0860. With respect to a credit for the residential services reclassification, AI states that Staff was not fully apprised of the relevant factual circumstances. After these services changed to competitive, AI explained that it made precisely the same reductions in their rates as it did in the rates of their noncompetitive counterparts. Therefore, AI claims there is no shortfall in the rate reductions that would otherwise have been required by the Plan. Moreover, AI contends these services have been incorporated in the Company's annual filing for calendar year 2000, which was submitted to the Commission on April 2, 2001 (administrative notice requested). AI argues that Staff's proposal would require the Company to reduce rates twice.

Commission Analysis and Conclusion

The Commission concludes that Staff's proposed one-time credit proposals are appropriate. We agree with Staff that AI improperly and unilaterally redefined the Installation Within 5 Days standard in a manner contrary to our intent, and the result of AI's redefinition has been an avoidance of service quality penalties related to installation. We reject AI's argument that we are applying a new definition retroactively to past reporting periods and hold that AI has been using an erroneous standard of its own making at its own risk. The record demonstrates that AI has used its installation definition consistently since before the Plan was adopted and we therefore find that Staff's adjustment is appropriate for that period of time.

With respect to the credit proposed by Staff for AI alleged premature reclassification of residential services, we believe that because AI returned these residential services to noncompetitive status voluntarily, the effect of returning them to the Plan is before us in this docket. Accordingly, we adopt Staff's adjustment to make consumers whole for AI's improper reclassification of residential services in 19 downstate exchanges.

I. Improper Reclassification Penalties

GCI/City's Position

GCI/City proposes a new penalty plan to discourage what it viewed as premature competitive classifications. GCI/City argues that, in order for the refund provisions to be invoked whenever appropriate, the Commission must investigate every improper reclassification, an undertaking which GCI/City claims is impractical given the broad range of services that AI has classified as competitive, and the lengthy and complicated proceedings required for an investigation. Additionally, GCI/City contend that AI has cited administrative problems associated with paying refunds, which have resulted in delays in refund payments.

GCI/City propose that the Commission adopt new safeguards against improper reclassification. First, GCI/City propose that on a going forward basis, the alternative regulation plan provide for financial consequences of up to $10,000.00 per day for competitive reclassifications that are later found to be improper by the Commission. City'GCI's propose penalty would be in addition to any refund requirements applicable pursuant to the PUA. Second, GCI/City propose AI would be required to reclassify improperly classified services back to their noncompetitive status and reduce the rates of those services back to their pre-competitive reclassification level within five days of a Commission Order rejecting a competitive classification.

Staff's Position

Staff adopted the GCI/City proposal, arguing that incorporation of such a penalty would be sound, and in keeping with the purposes of the Plan. In Staff's view, such a penalty would discourage improper reclassification, and in turn would improve the effectiveness of the Plan. Moreover, in light of the fact that the Commission would, under the proposal, have considerable discretion to assess culpability for improper reclassifications, and reduce or remit any penalties based on such an assessment, the proposal should not be considered confiscatory or unreasonable.

AI's Response

AI opposes the improper reclassification penalty proposal. AI argues that reclassification penalties are unreasonable as a matter of regulatory policy. AI acknowledges that there has been an ongoing disagreement between itself, the Commission Staff and GCI/City as to how much competition is required to support a reclassification under Section 13-502(b). However, AI points out that the Commission will likely provide substantial guidance on this issue in its Order in the pending reclassification case (Docket 98-0860) and that a separate proceeding (Docket 98-0861) has been initiated to establish rules for such classifications. Thus, AI contends that the fact that the parties are currently at odds and the fact that Docket 98-0860 has proved to be lengthy and complex are not grounds for punishing AI. AI contends that it did not act illegally by declaring the services to be competitive and further contends there is no evidence in the record that AI has acted in bad faith. In fact, AI notes that more of its competitive classifications have been approved than rejected by the Commission over the last several years.

Furthermore, AI argues that nothing in the Act permits the Commission to impose penalties in this situation. AI asserts that the Commission's powers and authority are defined by the terms of the Public Utilities Act. Business and Professional People for the Public Interest v. Commerce Commission, 136 Ill. 2d 192, 201, 240 (1989). AI further asserts that the Commission's authority to impose penalties is limited by Sections 5-202 and 13-516. The sanctions found Sections 5-202 and 13-516 apply to conduct which violates specific provisions of the Act or specific orders or rules of the Commission. In AI's view, neither of the Sections would permit the imposition of additional penalties, just because the Commission disagrees with a service reclassification. In addition, AI contends the law disfavors penalties in the absence of demonstrable bad faith, intentional wrongdoing or other comparable conduct, as being violative of due process. Southwestern Telegraph and Telephone Co. v. Danaher, 238 U.S. 482, 489-490, 35 S.Ct. 886, 888 (1915). Furthermore, AI opines that Section 13-502(e) already provides mechanisms to ensure that the Company does not profit from, and customers are not harmed by, classifications that are later overturned, because the Commission has the authority to require that rates be returned to their pre-reclassification level and that any rate increases be refunded to customers.

Finally, AI contends that GCI/City's reclassification penalty proposal is outside the scope of this proceeding. AI asserts this proceeding was initiated to review the functioning of the Plan under Section 13-506.1 which has nothing to do with competitive service reclassifications, which are governed by Section 13-502.

Commission Analysis and Conclusion

The Commission adopts the improper reclassification penalty proposal advanced by GCI/City. We agree that the Plan provides strong incentives to prematurely reclassify noncompetitive services, and conclude that this reclassification penalty provision will most certainly serve as a deterrent to the improper reclassification of non-competitive services.

VI. RATE REINITIALIZATION

GCI/City point to the Company's earnings and assert that AI's rates have not been and are not fair, just and reasonable. because they are over should be permitted to earn only its authorized return on equity established at the outset of the Plan. They would have the Commission perform a traditional analysis and reset rates according to an authorized level of earnings.

To the extent that rate re-initialization is defined as reducing rates to the level that would result from a traditional rate case, Staff recommends that there be no rate re-initialization. In other words, Staff opposes reinitialization based on, or due to, AI's earnings under the Plan because it does not consider those earnings and associated rates to be unfair, unjust or unreasonable.

According to Staff, the parties favoring reinitialization judge the reasonableness of AI's rates solely by the level of its earnings. In doing so, they fail to recognize on any deep level that alternative regulation provides non-competitive service subscribers with a "guarantee" that their overall rates will rise less than general inflation while AI is only given the "opportunity" to earn higher returns. If AI succeeds in earning higher returns, Staff notes that that is surely one of the possible outcomes that was to be expected. As such, it is not the basis for reinitialization.

In Staff's view, AI has earned well under the Plan primarily because it has been able to classify services as competitive when such effective competition did not actually exist. In doing so, it was able to raise prices for services out from under the cap. The remedy for this overreaching, Staff claims, is to move the services in question back into the non-competitive category.

Staff recommends that the Commission not reduce existing non-competitive rates in order to bring AI's earnings back to rate-of-return levels. Such action, Staff asserts, would lower the price of these services to below what would exist in competitive markets. The right thing to do, Staff maintains, is to reduce the prices of services that are returned to the non-competitive class back to what they were had they stayed under the Plan. (Staff Reply Brief at 27-28). According to Staff, the HEPO in Docket 98-0860, if adopted, sets out the appropriate end result. Staff expects that when that proceeding is ultimately completed, it will produce both a revenue reduction and a one-time refund to end users.

AI argues that rates should not be re-initialized. Such an action, it claims, is contrary to the principles of price regulation and would undermine the incentive to operate efficiently and invest in more risky technologies. AI further contends that the proposal to reinitialize rates on the basis of AI's financial performance during the single best Plan year, i.e., 1999, at a high economic period, ignores the reality of the changing economic climate during which competition and technological advances will be accelerating. AI maintains that its earnings over the initial review period of the Plan were impacted by three main factors:1) the superb economic environment; 2) the successful promotion of discretionary services; and 3) aggressive cost reductions. The Company also believes it unlikely that any of these conditions are sustainable.

Commission Analysis and Conclusion

In an earlier section of this Order, we observed that fair, just and reasonable rates are necessarily a function of earnings under the Plan, and that the Plan must produce rates and earnings that fairly balance ratepayer and shareholder interests in order to be lawful under section 13-506.1(b)(2). We applied the zone of reasonableness test to determine whether ratepayer and investor interests are fairly balanced under the Plan. The high earnings reported by AI and the even high earnings revealed by the Staff and GCI/City's revenue analyses convince us that a rate adjustment must be made in order to insure that AI's rates are just and reasonable.

We agree with GCI/City that the failure to reinitialize rates at the start of any new plan ensures that the going-in rates are not just and reasonable. Rate reinitialization on the basis of earnings is necessary because AI's earnings have been and are outside the zone of reasonableness.

Below we examine the earnings analyses presented by AI, Staff and GCI/City and conclude that rates must be reduced by $956 million to return them to just and reasonable levels, consistent with the reasonable cost of capital. We believe that once rates are reset at fair, just and reasonable levels, we can proceed with the Plan as we amend it in this Order. The Company will continue to be incented to improved productivity and cost savings as it has been under the Plan to date, and the statutory requirement that ratepayers and shareholders interests be fairly balanced will be met.

VIII. SERVICED QUALITY

A. The Statutory Standard

The evidence shows that customers were on the losing side of the equation when it came to receiving adequate performance levels in the service quality areas that matter most – POTS installation and POTS restoration (OOS>24). In addition, the evidence shows that the Company's performance in other critical customer performance areas not measured under the plan yet important to ratepayers, such as customer call center answer times and keeping installation and repair appointments, declined under the plan. The evidence has shown, as detailed in the CUB and AG Initial Briefs and in the GCI/City Reply Brief, that the existing service quality measures, benchmarks and penalty mechanism have been inadequate in incenting the Company to “at a minimum, maintain the quality and availability of telecommunications services”, as required under Section 13-506.1(b)(6) of the Act.

In their Proposed Order, the Examiners conclude that, in terms of meeting the statutory directive that the plan “at a minimum, … will maintain the quality and availability of telecommunications services”, the objective is “to have the Company maintain service quality at an acceptable level.” HEPO at Section VII, subsection C.

GCI’s position is and always has been that the service quality benchmarks and penalty provisions in the existing plan are inadequate to incent IBT to maintain service quality for noncompetitive services, given the Commission-acknowledged inducements in price cap regulation to “reduce expenditures in certain areas in such a manner as to impact service quality adversely.” Alt. Reg. Order at 58. Both Ms. TerKeurst’s and Staff’s service quality proposals to revise the measures and penalty provisions of the plan are designed to improve Company service quality performance in critical areas only to the extent that performance has been *substandard* during the life of the Plan. To the extent that the Company has accepted the addition on new service quality measures on a going forward basis is an acknowledgment that Staff’s and GCI’s proposals to add several new service quality measures to the price cap plan fits in with the notion of “maintaining” service quality.

That being said, however, Section 13-506.1(b)(6) states that the Commission “may approve the plan or modified plan and authorize its implementation only if it finds, after notice and hearing, that the plan or modified plan *at a minimum* will maintain the quality and availability of telecommunications services.” 220 ILCS 5/13-506.1(b)(6) (emphasis added). Accordingly, contrary to IBT’s assessment, it would not be unreasonable or illegal for the Commission to adopt service quality benchmarks aimed at improving performance, particularly in those areas where service quality performance has been lacking or declining.

For example, given the Company’s well-documented service quality failures, the Commission could appropriately determine that attaining improved service quality performance is “in the public interest”, pursuant to Section 13-506.1(b)(1). Moreover, as noted by Ms. TerKeurst, what constitutes acceptable service quality is a fluid concept. For example, technological advances may make prior service quality standards inadequate or outmoded, as illustrated by the proposed deletion of dial tone and operator intercept measures from the service quality mechanism. In addition, the mere maintenance of prior service quality levels may not always be adequate to ensure that the approved regulatory plan responds to changes in technology or encourages innovation in services, as contemplated by Section 13-506.1 of the Act. GCI/City Ex. 12.0 at 25.

That being said, the Examiners’ vague objective to “maintain service quality at an acceptable level” fails to recognize the Commission’s ability to attaining improved service quality performance is “in the public interest”, pursuant to Section 13-506.1(b)(1). In order to redress IBT’s service quality problems, the Commission must create a financial incentive for the Company to meet service quality benchmarks. In addition, the number of measures themselves must be expanded to truly reflect areas of customer concern, and the benchmarks must be set high enough to incite performance from the Company that “at a minimum will maintain the quality and availability of telecommunications services.”

B. Developing Benchmarks

In the HEPO, the Examiners adopt AI’s recommendation to set benchmarks for the designated service quality measures based on the Company’s average service quality performance over the last five years. HEPO at Section VII, Subsection C. The Examiners also conclude that where inadequate data exist or where the Company’s performance over the five-year period does not meet the minimum standards of service reflected in the Commission’s Par 730 rules, the Examiners adopt the standards in the Part 730 rules. Id.

The Examiners assert that using five years of data “better accounts for year-to-year and seasonal variations in conditions that affect service quality performance.” Id. GCI/City urge the Commission to reject this conclusion and rationale for several reasons. First, contrary to the Company’s position that the goal of maintaining service quality would be achieved by maintaining service quality at levels that have occurred *since* the plan’s inception, the evaluation of service quality should compare service quality before and after the plan’s implementation. This point is especially relevant to the Commission’s decision as to what benchmarks should be established for the measures included in the plan. IBT’s proposal to set benchmarks based on service quality levels achieved from 1995-1999 effectively locks degraded service quality performance into place as threshold levels.

As noted by GCI/City witness TerKeurst, such a plan would allow IBT’s inadequate performance to continue with no hope of or incentive for a return to even the best year under alternative regulation. GCI/City Ex.

12.0 at 25-26. This outcome is particularly inappropriate given the Company's substandard performance under the plan. Moreover, it puts IBT in the position of setting its own benchmarks for service quality performance. Id.

In addition, the Company's proposal to set benchmarks based on the average service quality performance over the last five years is inconsistent with Ameritech Illinois' own recognition of its inadequate service quality performance during several of those years. For example, Mr. Hudzik conceded that IBT's performance for Average Speed of Answer declined significantly between 1997 and mid-1999. Mr. Hudzik also concedes that IBT's installation and repair performance was inadequate during 1999 and 2000. AI Ex. 12.0 at 7-8. He also acknowledged that the Company has had problems keeping repair and installation appointments. Id. at 10. It is internally inconsistent for the Company to acknowledge some degradation in its service quality since the inception of the plan and then request that this degradation become the benchmark for evaluating whether service quality is maintained in the years to come. GCI/City Ex. 12.0 at 26.

As noted by Ms. TerKeurst, the Commission should adopt benchmarks for each individual service quality measure based on pre-plan levels, taking into account any other relevant factors. GCI/City Ex. 12.0 at 27. If pre-plan data is unavailable or otherwise inappropriate, the Company's own internal targets, should be used. For measures where the Company's performance during the 1995-2000 timeframe is the only source available, a benchmark generally should be based on the one year since the plan's inception that IBT's performance with regard to that particular measure was at its best. Id. To do otherwise, such as the Company and Staff recommend for purposes of setting benchmarks, ensures that service quality standards are locked in at less-than-adequate levels.

C. The Performance Measure and Benchmark Changes

1. Installation Within 5 Days

In their conclusion regarding the Installation Within 5 Days benchmark, the Examiners correctly find that the measure shall exclude order that are limited to vertical services. HEPO at Section VII, subsection D.1. However, they also assert that because no definitive evidence exists on the extent of the growth in vertical services before or during the Price Cap plan, it is "fair to re-set the benchmark." Id. Currently, AI is required to install 95.44% of all regular service orders within 5 days in order to avoid a service quality penalty. The Examiners' HEPO resets this benchmark to 90%, consistent with the minimum standard in the Commission's Part 730 rules, because "available data for the measure, as we here define it, does not establish a performance level consistent with the standard in our Part 730 rules, i.e. 90%." Id.

The Examiners conclusion in this regard should be rejected. Lowering the benchmark because AI has failed to meet even the minimum service quality standard on regular service installations is inconsistent with the statutory requirement that service quality be, at a minimum, maintained under the plan. Moreover, as noted earlier in this Brief, the Company's performance in the Installation Within 5 days category has been woefully inadequate in recent years. It is counterintuitive for the Commission to lower its expectations of the Company merely because AI has failed to meet minimum service quality standards – especially given the Commission's desire to establish a plan that incents the Company to improve service quality in this critical area.

Accordingly, GCI/City urge the Commission to retain the 95.44% benchmark for this service quality measure.

2. Out of Service Over 24 Hours

In this section of the HEPO, the Examiners dodge the question of whether the Company should be instructed to alter the way it calculates its OOS>24 Hours measure. GCI/City witness TerKeurst presented uncontroverted testimony that the Company overstates the "Act of God" or weather-related exceptions to meeting this benchmark (thereby improving their performance numbers) by removing "Act of God" outages from the numerator (which represents the number of outages that exceeded 24 hours) and then dividing that number by a figure that represents the total of all outages, *including "Act of God" outages.*

The Commission should adopt Ms. TerKeurst's recommendation to require the Company, when calculating its performance on this measure, to exclude outages associated with "Acts of God" from the denominator, just as they have been from the numerator. To permit the Company to continue calculating this measure in this flawed manner gives AI the green light to distort its performance in this critical service quality area.

3. Repeat Trouble Rate – Installation and Repair

While the HEPO correctly recognizes the need to measure repeat trouble rates for installation and repair categories, the Examiners adopt a single measure for these two critical service quality performance areas, separate the benchmarks and divide the assigned penalty equally between them.

GCI/City urge the Commission to separate these two critical performance measures and assign a benchmark of 5% for installation repeats and 10% for repair repeats, based on the Company's own internal targets. Adopting the Company's proposed benchmarks of 16.90% for installation repeats and 13.92% for repair repeats, while also dividing the penalty between these two service quality areas, effectively locks in the Company's poor performance in these areas. It also minimizes AI's incentive to improve its service quality in this area.

For these reasons, GCI/City urge the Examiners to adopt Ms. TerKeurst's recommendation to separate these important measures and implement benchmarks of 5% for installation repeats and 10% for repair repeats.

4. Missed Installation Commitments

Although the Examiners recognize the need for measuring AI's failure to meet its installation commitments, they inappropriately fail to distinguish between AI-promised installation appointments (requiring field visits) and installation commitments (promises to install by a date certain). In addition, the Examiners again lock in a deficient level of service quality by adopting a benchmark of 90% for regular service commitments met because of a lack of data that excludes vertical services.

GCI/City urge the Examiners to separate the Missed Installation Appointment and Missed Installation Commitment categories, and reject the benchmark adopted by the Examiners in favor of a 1% benchmark for each of these measures, based on AI's own internal measures. As noted earlier in the GCI/City Reply Brief, during cross-examination, the Company admitted that when selecting the benchmarks, the organizations do *not* pick benchmarks that they cannot meet. Tr. 1840. In addition, Company witness Hudzik admitted that IBT has met its own internal service quality benchmarks, and even modified them to a stricter level to inspire improved performance. Tr. 1842, 1856-1858.

Accordingly, GCI urges the Commission to adopt Ms. TerKeurst's proposed POTS % Missed Installation Commitments Due to Company Reasons measure and POTS % Missed Installation Appointment measures and incorporate a 1% benchmark for each.

5. Average Speed of Answer – Repair

Having correctly recognized Average Speed of Answer – Repair as a critical customer service category by adding it as a measure in the plan, the Examiners, unfortunately, adopt a lax standard that relies on data derived during the price cap plan. Accordingly, this benchmark is unsuitable for determining whether the plan will maintain service quality.

GCI/City urge the Commission to adopt Ms. TerKeurst's proposed "80% Answered Within 20 Seconds" benchmark, which is consistent with the Company's own internal performance target. The notion that the Company's own internal targets are too strict to use as benchmarks is unpersuasive, given that AI witness Hudzik testified that IBT has met it own internal benchmarks and, in fact, modifies them to a stricter level to inspire improved performance.

At a minimum, a 45.8 second benchmark should be established, which represents the Company's best annual average performance during the life of the plan. Adoption of this benchmark would then ensure that service quality is "at a minimum, maintained", consistent with the statutory directive.

6. Average Speed of Answer – Customer Calling Centers

Again, GCI/City endorse the Examiners recognition that a critical service quality area from a customer's standpoint is the average time it take AI to respond at its calling centers, having adopted it as a new standard for the new plan. However, the Examiners again make the mistake of locking in what is essentially deficient service quality expectations by using the minimum Part 730 requirement of 60 seconds average answer time as the benchmark. In addition, the Examiners' approach fails to separate business and residential call center performance.

GCI/City urge the Commission to separate the call center performance measure so that residential call center and business call center answer times are monitored separately. The record evidence supports such a distinction. First, IBT processes residential and business customer calls in separate centers. Second, because IBT currently monitors and measures its average speed of answer performance for each type of customers separately, a requirement that the Company report is performance separately for each type of customer group will add no burden to IBT. Third, separating the measures will ensure that the Company does not discriminate in its response time to residential customers when compared to business customers. GCI/City Ex. 12.0 at 37. The Company acknowledged during cross-examination that, from a mathematical standpoint, not disaggregating this measure could result in one customer class receiving significantly different service quality performance from the Company than the other class. Tr. 1839.

Moreover, as detailed by Ms. TerKeurst, the Company's performance has been quite erratic to varying degrees in both the residential and business call centers. GCI Ex. 2.0 at 40. It is essential to separate the business and residential call center answering times in order to ensure that the Company does not mask service quality differences between customer classes. GCI's proposed separation of the measures also guards against discriminatory behavior favoring business customers. GCI Ex. 12.1 demonstrates that calls to business call centers are currently answered much more promptly than calls to residential centers.

Ms. TerKeurst testified that IBT's established target for residential customers call centers is 60 seconds. However, the Company's internal target for business call centers is 80% of calls answered within 20 seconds. This 80% of calls answered within 20 seconds also be adopted for residential customer call centers. Staff also proposed that this benchmark be employed, albeit for a combined residential/business customer call measure.

An assessment of whether IBT's service quality is being maintained should compare its current performance with its performance during years prior to alternative regulation. For service quality measures for which IBT has not provided pre-plan data, such as these measures, the Company should generally be held to meeting either its own internal standard or the performance it achieved during the "best" alternative regulation year for which data is available.

Given the erratic, differing answer times between the residential and business customer call centers as described above, and the Company's own internal target, the Commission should adopt GCI's proposed benchmark of 80% within 20 seconds and maintain separate measures for the residential and business customer call centers.

7. Percent of Calls Answered

Confused by the record, the Examiners in this portion of the HEPO direct the parties to "bet**ter explain the measure, benchmark and their respective positions in their Exceptions.**

To clarify, GCI/City recommends the inclusion of abandoned call measuresfor the residential, business and repair customer call centers, in accordance with Ms. TerKeurst's recommendations. As discussed by Ms. TerKeurst, these measures would be very useful in identifying any trend in the percent of calls that are abandoned because of excessive delays in response time. Staff witness Cindy Jackson pointed out in testimony that IBT data suggests that an increase in the average speed of answer results in an increase in the percent of calls abandoned by customers. Moreover, as detailed by Ms. TerKeurst, Company data shows that the percent of calls answered was markedly better for business than residential customer call centers. GCI/City Ex. 2.0 at 45. This phenomenon supports the establishment of separate Percent of Call Answered measures for the residential and business call centers. Measuring such data is equally important for repair call offices.

In short, the Percent of Call Answered measure provides another indicator of IBT's accessibility and responsiveness to customer inquiries and service needs. Although the Company has a 90% target level as its own internal measure, a 95% level should be established as the benchmark for each of these three measures. As noted by Ms. TerKeurst, IBT has been exceeding the 90% target benchmark. GCI/City Ex. 2.0 at 46. Thus, its use as a standard could result in a degradation of service. Instead, the benchmark should be based on IBT's actual performance to safeguard against erosion of service quality as required by Section 13-506.1(b)(6) of the Act. Moreover, use of such a standard would be consistent with the Commission's rationale for establishing a standard for the Company's % Installation Within 5 Days measure that was above the standard in Part 730 of the Commission's rules. See Alt. Reg. Order at 58.

Accordingly, the Commission should adopt three separate Percent of Call Answered standards, with a benchmark of 95 percent, for residential, business and repair call centers.

8. Mean Installation and Repair Intervals

The HEPO fails to adopt, let alone address, the GCI/City proposals to create new benchmarks measuring the Company's Mean Installation Interval and Mean Repair Interval. Creation of these benchmarks is critical to diminish any incentive the Company might have to stop attempting to meet the repair and installation benchmarks because of a recognition that performance has been inadequate to satisfy the annual benchmarks.

Staff witness Sam McClerren testified that the degree by which the Company misses a service quality benchmark is of concern to the Commission. Tr. 1798. If the Company misses the Installation Within 5 Days benchmark at any given time, the situation can become markedly worse depending on the amount of time beyond the five-day interval customers are forced to wait. Currently IBT maintains a POTS Mean Installation Interval that measures the average business days taken to install POTS service only. GCI/City Ex. 2.0 at 47. It also tracks installations for both POTS and other services combined. Id. at 46-47. Financial consequences for failure to meet a POTS Mean Installation Interval benchmark would provide an invaluable safeguard against prolonged delays for installations that take more than 5 days. Such a measure would discourage the Company from moving customers whose POTS has not been installed within 5 days to the bottom of the work queue before service is ultimately installed. GCI Ex. 12.0 at 40. The measure would encourage IBT to install all POTS lines as soon as possible regardless of whether the Installation-Within-5-Days measure had been met.

In its Brief, IBT argues that "it has never engaged in the practice that Ms. TerKeurst alleges", and hence suggests that no factual basis exists for adopting the POTS Mean Installation Interval measure. IBT Brief at 82. This argument should be rejected. First, the Company cites no testimony from any Company witness who asserted this has never happened. Second, the record evidence shows and it is common knowledge that many IBT customers were forced to wait weeks last summer for the installation of a POTS line. AI Ex. 12.0 at 9. Accordingly, including a financial incentive that would discourage supervisors from letting customer requests for POTS lines languish in a work queue when it is determined that the Installation Within 5 Days benchmark has not been reached is critical to the maintenance of service quality.

Ms. TerKeurst recommended that a benchmark for this measure be set at four business days. If IBT is supposed to complete 95.44% of installations within five days, it is reasonable that the standard for mean installation intervals would be less than five business days. GCI/City Ex. 2.0 at 48. It is important to remember that the word "mean" is defined as the mid-point between two extremes. This definition highlights the conservative nature of the 4-day benchmark. GCI urges the Commission to adopt this proposed standard and benchmark.

The Commission should also adopt the GCI/City-proposed POTS Mean Time To Repair measure. Like the POTS Mean Installation Interval, including the GCI-proposed POTS Mean Time to Repair measure in the service quality component of any alternative regulatory plan would provide the Company with a financial incentive to ensure that service outages that exceed 24 hours are not neglected even longer. GCI/Ex. 12.0 at 41. Currently, IBT measures its POTS Mean Time to Repair, with an internal benchmark of 21 hours. GCI Ex. 2.0 at 49. Ms. TerKeurst testified that there is reason for the Commission to monitor this performance area. The Company's mean time to repair POTS lines has significantly increased from an average of 24.32 hours in 1999 to an average of 40.25 hours in 2000 (through September), with the mean time to repair POTS lines hitting 77.72 hours in September, 2000. Id. at 49-50. Given the Company's poor performance in the POTS Mean Time to Repair area, establishing a target level of 21 hours would encourage improvement and should be adopted.

Again, the Company argues in its Brief that no evidence exists that the Company engaged in behavior wherein outages that were not repaired within 24 hours were put on the backburner. Again, this argument misses the mark. A check of the citations offered as support for this statement in the Company's Brief reveals that no witness ever made such an assessment. The fact is that a financial incentive currently exists, whether it has been acted upon or not, for technician crews to pass over requests for repair if it can be determined that the outage has surpassed the 24-hour mark.

The record evidence shows that the Company's performance in the area of repairing service outages needs to be monitored closely given its abysmal record at satisfying the OOS>24 benchmark. GCI urges the Commission to provide the Company with a financial incentive to restore service as quickly as possible to all customers by including a POTS Mean Time to Repair measure in the service quality component of any alternative regulatory plan approved in this docket.

C. Phase-In of New Benchmarks

The HEPO adopts AI's proposal to phase-in new service quality benchmarks over three years. For each new benchmark adopted in the Order, the benchmark for the first year is to be set two percent from the benchmark adopted, the benchmark for the second year will be set one percent from the benchmark adopted and the benchmark in the third and subsequent years will be set at the benchmark adopted. HEPO at Section VII, Subsection E.

The Examiners explain this generous concession with the statement that "a three-year phase-in will better coincide with both the Company's planning and budgeting cycle and with the Commission's annual review of the Plan. Id. Any phase-in of the service quality standards adopted in this Order should be rejected for a couple of reasons.

First, the Commission did not believe such a phase-in was necessary when it first established the eight benchmarks that are a part of the existing service quality penalty mechanism. The notion that it could be financially affected by poor service quality performance was just as new to AI in 1994 as it is in 2001. Nevertheless, the Commission ordered no phase-in of benchmarks.

Second, all of the benchmarks adopted in the HEPO and proposed by GCI/City are service quality measures that the Company already tracks. Accordingly, there is no need to accommodate some alleged need to "prepare" its planning and budgeting cycles for the additional measures.

Accordingly, GCI/City urge the Commission to reject any kind of phase-in of the newly adopted service quality benchmarks.

D. Incentive Structure

In their Conclusion regarding the appropriate incentive or penalty structure to be adopted on a going-forward basis, the Examiners write that "we regard the Company's specific performance of its service quality obligations as our preeminent goal." HEPO at Section VII, Subsection F. GCI/City take exception with this declaration, proposing instead that the Commission's preeminent goal in reviewing the current Price Cap Plan is to satisfy the statutory directives that require, among other provisions that, at a minimum, service quality be maintained and rates be fair, just and reasonable. The Commission should not lose sight of the fact that both the General Assembly and customers' value fair, just and reasonable rates as much as the maintenance of service quality.

That being said, GCI/City supports the Examiners conclusions that:
(1) remove the service quality penalty provision from the price cap formula;
(2) strengthen existing penalties to incite the investment the Company needs to make in both manpower and equipment to maintain basic service quality; and

(3) provide the credits to those customers directly affected by service quality failures.

GCI/City, however, are particularly troubled by certain statements in the HEPO that allow the Company to deduct individual customer credits and "reasonable administrative costs" associated with implementing the penalty and customer compensation schemes from the penalty amounts the Company might otherwise owe for failure to meet any of the adopted benchmarks. HEPO at Section VII, F. In addition, GCI/City except to the Examiners' assumption that the $30 million penalty for violations of the OOS>24 standard supplanted, rather than was added to, the existing penalty in the price cap formula. Other corrections or exceptions to proposed language in this Section of the HEPO follow.

1. Customer Credits And "Reasonable Administrative Costs" Should Not Be Deducted From AI's Annual Service Quality Penalty Amount.

The Examiners' conclusion that AI's customer credits and "reasonable administrative costs" should be deducted from any annual service quality penalty amounts paid at the end of each year should be rejected for several reasons.

First, permitting the Company to deduct from its overall penalty amount all customer credits paid during the year essentially removes any incentives it might have to keep customer credits (and therefore poor service quality performance) to a minimum. If the Company knows, for example, that it will recoup any and all individual customer credit penalties from the overall penalty amount, it is only reasonable to assume that poor performance in these areas takes on a lesser importance from a financial perspective each year.

This assumption is valid when one considers that U.S. tax laws hope to encourage charitable contributions by providing income deductions for individual and corporate taxpayers. While it perhaps cannot be said that AI will be *incited* to miss the repair and installation benchmarks, it is fair to say that the incentive to meet these benchmarks dissipates if the Company knows that it ultimately will be reimbursed, assuming annual service quality benchmarks are missed.

For this reason, the Commission should strike the language in the HEPO that permits the Company to deduct the individual customer credits from any penalty owed at the end of each year.

The Examiners' caveat that "reasonable administrative costs" should be deducted from the annual service quality penalties paid is another invitation to AI to engage in bad behavior. First, as is becoming increasingly clear in the AI Merger Savings Docket (01-0128), the litigation of annual reports of expenses is a complicated process. Given the Examiners' interest in simplifying the penalty component of the plan, it makes no sense from a policy or legal perspective to permit the Company to introduce in each annual filing docket its own, unaudited assessment of what its penalty structure administrative costs were for the year. It is a given that Staff and Intervenors would want to analyze the figures provided by AI and cross-examine the numbers to the extent deemed necessary. The existing annual filing proceeding, however, is not set up to accommodate such litigation. Indeed, the Commission in its last annual filing order acknowledged this fact when it ordered the establishment of separate proceedings for the litigation of merger savings and cost estimates.

Second, permitting the Company to recoup its "reasonable administrative costs" is such a vague instruction as to invite abuse. No specificity is provided as to what would constitute "reasonable" costs. GCI/City urge the Commission not to attempt to define such costs in its final Order, but merely reject the notion of reimbursement altogether.

Moreover, it is a given that the Company incurs "administrative costs" each time it is required after the Commission's annual filing order to reduce rates in accordance with the price cap formula. The Commisson did not see fit to award such compensation in 1994 when it established the existing service quality penalty mechanism, and it should likewise not do so now.

3. OOS>24 Penalty

The Examiners also erred when they wrongly assumed that the $30 million penalty approved by the Commission in the Merger Order for AI's failure to meet the OOS>24 Hours standard supplanted the original penalty structure in the price cap formula. In fact, the Commission stated in that Order:

In subsequent full calendar year periods (including calendar year 2000), the Joint Applicants shall demonstrate compliance in the same manner currently used by the Commission and Ameritech Illinois to measure the Company's compliance with the OOS>24 service standard or face a one-time, $30 million assessment, *separate and apart from any annual rate reduction resulting from the service quality component of the company's Alternative Regulatory Plan.*

Merger Order at 24 (emphasis added). This highlighted language makes clear that the Commission intended that the $30 million penalty was a condition of approval of the Merger, and was to be assessed in addition to any service quality penalty included under alternative regulation. GCI/City urge the Commission, therefore, to ensure that violations of the OOS>24 standard are punished with both the penalty mechanism approved in this Order *and* the $30 million penalty the Commission ordered as a condition in the Merger docket.

3. Customer-Specific Penalties / Cell Phones

The Proposed Order does not provide for any customer-specific penalties coincident with the Company's failure to keep installation and repair appointments. Likewise, the HEPO concludes that the provision of cell phones to customers who personally experience installation and service-outage-repair delays at the hand of the Company would be administratively unwieldy.

To incent the Company to honor its appointments with customers and to schedule appointments realistically, GCI/City urge the Commission to include a penalty provision that would result in a $50.00 payment or credit to the consumer, unless the Company notifies the consumer 24 hours in advance. In addition to creating appropriate customer service incentives, this measure provides reasonable compensation to consumers who have lost time from work or otherwise managed their schedule to await a repair or installation appointment. In addition, this penalty level is consistent with the level recently approved by the General Assembly in the new telecommunications bill now awaiting the Governor's signature.

In addition to providing the above direct consumer compensation, GCI/City proposes that IBT be ordered to establish a cellular telephone loaner program, so people who are without service can have telephone service available to them while they await installation or repair. GCI Ex. 2.0 at 87. Because so many CLECs are resellers, they are still dependent on IBT for basic service connections and some repairs. It is therefore crucial that this program be available to wholesale as well as retail customers, so IBT does not use it to obtain a competitive advantage over CLECs. GCI Ex. 2.0 at 88.

These additional direct customer compensation measures are necessary to insure that the people inconvenienced by service quality degradation are compensated for the time they spend without telephone service, for the time and money they lose waiting for technicians who never appear, for the money they lose by having to obtain replacement service, for the money lost from missing work days or business calls, and for the increased risk associated with being unreachable when medical and other emergencies arise.

4. Wholsale Service Quality

The Examiners fails to address wholesale customer service quality, concluding that such issues can be raised and addressed in other proceedings. HEPO at Section VII, Subsection G. 3. The Commission should reject the temptation to ignore this important issue.

First, to the extent that alternative regulation is designed to foster a transition to a more competitive environment, the Commission must recognize that the issue of whether potential competitors, who must purchase network elements and other services from the incumbent carrier, receive adequate service from the monopoly carriers is relevant.

As GCI/City noted in its Briefs, consumers of wholesale services, such as CLECs who provide local service through resale or UNEs, should also be entitled to compensation. Otherwise IBT consumers would receive compensation for poor quality service, but CLECs and their customers would not receive equal treatment. GCI Ex. 2.0 at 84. This could have the unintended consequence of further degrading services to CLECs, and undermining the growth of competition, because IBT may give higher priority to consumers for whom it is obligated to pay compensation than to CLEC customers.

Accordingly, GCI/City urge the Commission to strike the conclusion on this issue offered by the Examiners and apply all penalty mechanisms to wholesale customers as well.

5. Miscellaneous Penalty Exceptions

GCI/City strongly except to the final statement made by the Examiners in this portion of the HEPO, which reads: "In closing out this section of our Order, we remind AI that nothing is expected of the Company only that it work to maintain service quality at the required levels." HEPO at Section VII, Subsection F. The notion that "nothing is expected of the Company" except to maintain service quality at the required levels flatly contradicts the statutory directive that any alternative regulatory plan approved by the Commission shall satisfy the criteria listed in Section 13-506.1(b). Indeed, when it comes to creating an alternative regulatory plan, the General Assembly made it clear that much is expected of the Commission in terms of satisfying the statutory goals articulated throughout the Act, as specifically set forth in Section 13-506.1(a) through (f). The Examiners' conclusion in this regard, therefore, should be stricken from the Commission's final Order.

With respect to the Installation Within 5 Days customer credit portion of the HEPO, the Examiners state that one-half of the non-recurring installation charges should be credited to customers who have their order completed within *seven* to nine business days. No reason is provided for waiting until the seventh day to provide a customer credit, rather than the sixth day. GCI/City assume this is an unintentional mistake in need of correction. Moreover, adjusting this portion of the Order to read "*six* to nine days" is consistent with the proposed new Telecommunications legislation now awaiting the Governor's signature.

SERVICE QUALITY – GOING FORWARD

A. The Legal Standards

In its Brief, IBT argues that the Act, specifically Section 13-506.1(b)(6), requires that an alternative regulatory plan *maintain*, not improve, service quality, and that all parties concurred with this assumption. IBT Brief at 62. The Company further opines that certain aspects of Staff's and GCI's proposals would require it to improve, and not simply maintain, service quality. Id. at 63. The Company asserts that Staff and GCI changed their positions during the case to suggest that in fact the Commission may, when approving an alternative regulatory plan, require the Company to *improve*, and not just maintain, service quality. Id. IBT cites GCI/City Ex. 12.0 at pages 21-23 as support for this assertion.

In their briefs, both GCI and Staff argue that before the Commission can approve any alternative regulatory plan in this proceeding, it must find that the plan "will, at a minimum, maintain the quality and availability of telecommunications services" pursuant to Section 13-506.1(b)(6) of the Act. GCI notes also that the policy of the State of Illinois is that:

> all necessary and appropriate modifications to State regulation of telecommunications carriers and services should be implemented *without unnecessary disruption to the telecommunications infrastructure system or to consumers of telecommunications services* and that it is necessary and appropriate to establish rules to encourage and ensure orderly transitions in the development of markets for all telecommunications services.

220 ILCS 5/13-103(c), 13-506.1(a)(emphasis added). Accordingly, GCI states, service quality under an alternative regulation plan must not deteriorate, and the Commission may require that a plan result in an enhancement of service quality. Staff's Reply Brief concurs with this assessment. Pursuant to Section 13-506.1 of the Act, GCI argues that an enhancement of service quality is "in the public interest," "encourages innovation in services," and "facilitates the broad dissemination of technical improvements to all classes of ratepayers." 220 ILCS 5/13-506.1(b)(1), (a)(2), (a)(4). Moreover, GCI asserts that a plan that has resulted in degraded service quality is in violation of section 13-506.1(b)(6) as well as the above legislative policies, and cannot be continued unless significant modifications to the plan are made to eliminate the service quality problems and insure that service quality at a minimum will be returned to historic levels, according to GCI.

GCI further disputes IBT's suggestion that GCI's position has somehow shifted over the course of the docket. GCI noted in its Reply Brief that, in fact, Ms. TerKeurst testified that her proposals to add new service quality benchmarks and to strengthen the service quality penalty provision are designed to correct the failure of the existing service quality provisions of the plan. Ms. TerKeurst stated at page 23 of her rebuttal that the benchmarks she proposes "not only are reasonable but also approximate Ameritech Illinois' actual historical performance in many instances."

GCI states that its position is and always has been that the service quality benchmarks and penalty provisions in the existing plan are inadequate to incent IBT to maintain service quality for noncompetitive services, given the Commission-acknowledged inducements in price cap regulation to "reduce expenditures in certain areas in such a manner as to impact service quality adversely." Alt. Reg. Order at 58. Both Ms. TerKeurst's and Staff's service quality proposals to revise the measures and penalty provisions of the plan are designed to improve Company service quality performance in critical areas only to the extent that performance has been *substandard* during the life of the Plan. GCI states that to the extent that the Company has accepted the addition on new service quality measures on a going forward basis is an acknowledgment that Staff's and GCI's proposals to add several new service quality measures to the price cap plan fits in with the notion of "maintaining" service quality.

Commission Conclusion

Section 13-506.1(b)(6) states that the Commission "may approve the plan or modified plan and authorize its implementation only if it finds, after notice and hearing, that the plan or modified plan *at a minimum* will maintain the quality and availability of telecommunications services." 220 ILCS 5/13-506.1(b)(6). Accordingly, service quality under an alternative regulation plan must not deteriorate, and the Commission may require that a plan result in an enhancement of service quality. An enhancement of service quality is "in the public interest," "encourages innovation in services," and "facilitates the broad dissemination of technical improvements to all classes of ratepayers." 220 ILCS 5/13-506.1(b)(1), (a)(2), (a)(4). A plan that has resulted in degraded service quality is in violation of section 13-506.1(b)(6) as well as the legislative policies articulated in Section 13-103(c), and cannot be continued unless significant modifications to the plan are made to eliminate the service quality problems and insure that service quality at a minimum will be returned to historic levels.

Accordingly, contrary to IBT's assessment, it would not be unreasonable or illegal for the Commission to adopt service quality benchmarks aimed at improving performance, particularly in those areas where service quality performance has been lacking or declining. For example, given the Company's well-documented service quality failures, the Commission could appropriately determine that attaining improved service quality performance is "in the public interest", pursuant to Section 13-506.1(b)(1). Moreover, as GCI correctly observes, what constitutes acceptable service quality is a fluid concept. For example, technological advances may make prior service quality standards inadequate or outmoded, as illustrated by the proposed deletion of dial tone and operator intercept measures from the service quality mechanism. In addition, the mere maintenance of prior service quality levels may not always be adequate to ensure that the approved regulatory plan responds to changes in technology or encourages innovation in services, as contemplated by Section 13-506.1 of the Act.

In order to redress IBT's service quality problems, the Commission must create a financial incentive for the Company to meet service quality benchmarks. In addition, the number of benchmarks themselves must be expanded to truly reflect areas of customer concern.

B. Existing and Proposed Measures and Benchmarks

The current plan contains eight performance measures. IBT, GCI and Staff agree that of the existing measures, dial tone within 3 seconds can be eliminated because it has become obsolete. Both Staff and GCI proposed the addition of several new service quality measures to any price cap plan adopted by the Commission. Staff and GCI further proposed the addition of service quality standards and benchmarks for Missed Installation Appointments, Missed Repair Appointments, Repeat Trouble Rate (Installation and Repair), Abandon Rate and the consolidation of the Operator Speed of Answer for Toll, Directory Assistance and Information. GCI proposed an additional five more measures, as discussed below. IBT concurred with the additional standards recommended by Staff, except for the Abandon Rate, which the Company suggested be replaced with an Answering Performance Standard. Staff accepted this modification.

GCI proposes that the following benchmarks[1] be included in any alternative regulation plan approved by the Commission:

a.	POTS % installations within 5 days *	95.44%
b.	Trouble reports per 100 access lines *	2.66
c.	POTS % out of service for more than 24 hours *	5.0%
d.	Operator average speed of answer—toll and assistance *	3.6 seconds
e.	Operator average speed of answer—information *	5.9 seconds
f.	Operator average speed of answer—intercept *	6.2 seconds
g.	Trunk groups below objective *	4.5/year
h.	POTS % Out of Service Over 24 Hours	5.0%
i.	Average Speed of Answer	
	1. Residential Customer Call Centers	80% w/in 20 seconds
	2. Business Customer Call Centers	80% w/in 20 second
	3. Repair Centers	80% w/in 20 seconds
j.	% of Calls Answered	
1.	Residential Customer Call Centers	95 %
2.	Business Customer Call Centers	95 %
3.	Repair Centers	95 %
k.	POTS Mean Installation Interval	4 business days
l.	POTS Mean Time to Repair	21 hours
m.	POTS % Installation Trouble Report Rate (7 days)	5%

[1] Measures (a) - (g) are already in the plan and are indicated with an asterisk.

n. POTS % Repeat Trouble Report Rate (within 30 days) 10%

o. POTS % Missed Installation Commitments – Company Reasons 1%

p. POTS % Missed Repair Commitments – Company Reasons 1%

q. POTS % Missed Installation Appointments – Company Reasons 1%

r. POTS % Missed Repair Appointments – Company Reasons 1%

The additional measures proposed above are premised on (1) a recognition that "plain old telephone service", or "POTS" is an essential service not available from other providers that must be provided reliably and promptly; and (2) uncontroverted evidence that AI prioritizes its service quality performance to coincide with meeting those measures that the Commission (and other state commissions) has earmarked for financial penalties should the Company's performance be less than adequate. GCI/City Ex. 12.0 at 21-22. All of the measures proposed are already monitored and specifically tracked in reports filed with the FCC or as part of its merger obligations within the NARUC Service Quality Reports. Id. Accordingly, any claims by the Company that including these measures within any new alternative regulatory plan would place undue burdens on AI are unpersuasive. Further, as discussed below, the benchmarks incorporated in the measures are reasonable and approximate IBT's historical performance where such information is available. GCI/City Ex. 12.0 at 23.

In its Brief, the Company complains that GCI's proposed additional service quality measures, if adopted, would increase the number of service quality measures subject to the Alternative Regulation Plan by a factor of two and a half, from eight to twenty. The Company, however, agreed to the addition of two new service quality standards and benchmarks relative to speed of answer for calls to the business and repair offices. The Company proposes to set benchmarks based on the average service quality performance over the last five years. Staff proposes to establish benchmarks based on the Company's average performance during the 1998-1999-time period.

GCI responded that, in fact, IBT exaggerates the differences between GCI's and Staff's proposals. GCI's proposal adds only five measures to the four new measures proposed by Staff. The additional GCI measures are: (1) POTS Mean Installation Interval, (2) POTS Mean Time to Repair, (3) POTS % Installation Trouble Rate (7 days), (4) POTS % Missed Installation Commitments—Company Reasons and (5) POTS % Missed Repair Commitments – Company Reasons. According to GCI, the only other differences between the Staff and GCI proposals for measures to include in the plan are due to the fact that Staff proposed to reduce more of the existing eight standards than GCI witness TerKeurst proposed and that Ms. TerKeurst proposed to disaggregate two measures, Average Speed of Answer at Business Offices and % Calls Completed at Business Offices, for residential and business customers to better monitor treatment of those customer classes.

In its Reply Brief, GCI advises the Commission that as it assesses which measures and benchmarks should be included in any alternative regulatory plan approved in this docket, it should keep in mind two relevant, uncontroverted points established in the record. First, AI witness Hudzik conceded that IBT prioritizes its service quality performance to coincide with meeting those benchmarks that this Commission and other state commissions deem most important, i.e., those service quality measures and benchmarks whose failure results in financial consequences. AI Ex. 12.0 at 43. In fact, GCI states, IBT will go so far as responding to customer calls from one state before another's at business offices in order to meet state service quality requirements. GCI/City Ex. 12.0 at 22-23. As a result, in order to, "at a minimum, maintain the quality and availability of telecommunications services", the Commission must identify and specify as measures in the plan service quality areas that it deems necessary to achieving that goal. 220 ILCS 5/13-506.1(b)(6). GCI states that its proposed service quality measures, as recommended by Ms. TerKeurst, recognize critical service quality areas that matter most to customers.

GCI also notes that the adoption of the additional GCI-proposed measures would place no undue burdens on IBT. The Company already monitors, compiles and reports its performance on *all* of the additional measures proposed by Ms. TerKeurst in the form of ARMIS data filed with the FCC or as part of its merger obligations within the NARUC service quality reports. GCI/City Ex. 12.0 at 23. Accordingly, GCI replies that the suggestion made by IBT that GCI has redefined or invented many of the measures, and that adding them will unduly burden the Company, is untrue. GCI points out in its Reply Brief that as a matter of fact, IBT witness Hudzik confirmed that "the categories Ms. TerKeurst uses are the same names, essentially, as measures that are used (by IBT) internally."

Tr. 1832.

GCI further states that contrary to the Company's position that the goal of maintaining service quality would be achieved by maintaining service quality at levels that have occurred *since* the plan's inception, the evaluation of service quality should compare service quality before and after the plan's implementation. This point is especially relevant to the Commission's decision as to what benchmarks should be established for the measures included in the plan. IBT's proposal to set benchmarks based on service quality levels achieved from 1995-1999 effectively locks degraded service quality performance into place as threshold levels, according to GCI.

GCI further argues that such a plan would allow IBT's inadequate performance to continue with no hope of or incentive for a return to even the best year under alternative regulation. GCI/City Ex. 12.0 at 25-26. This outcome is particularly inappropriate given the Company's substandard performance under the plan, according to GCI. Moreover, it puts IBT in the position of setting its own benchmarks for service quality performance. Id.

In addition, the Company's proposal to set benchmarks based on the average service quality performance over the last five years is inconsistent with Ameritech Illinois' own recognition of its inadequate service quality performance during several of those years, according to GCI. For example, Mr. Hudzik conceded that IBT's performance for Average Speed of Answer declined significantly between 1997 and mid-1999. Mr. Hudzik also conceded that IBT's installation and repair performance was inadequate during 1999 and 2000. AI Ex. 12.0 at 7-8. GCI notes that Mr. Hudzik also acknowledged that the Company has had problems keeping repair and installation appointments. Id. at 10. According to GCI, it is internally inconsistent for the Company to acknowledge some degradation in its service quality since the inception of the plan and then request that this degradation become the benchmark for evaluating whether service quality is maintained in the years to come. GCI/City Ex. 12.0 at 26.

GCI proposes that the Commission adopt benchmarks for each individual service quality measure based on pre-plan levels, taking into account any other relevant factors. GCI/City Ex. 12.0 at 27. If pre-plan data is unavailable or otherwise inappropriate, the Company's own internal targets, should be used. For measures where the Company's performance during the 1995-2000 timeframe is the only source available, a benchmark generally should be based on the one year since the plan's inception that IBT's performance with regard to that particular measure was at its best. Id. GCI contends that to do otherwise, such as the Company and Staff recommend for purposes of setting benchmarks, ensures that service quality standards are locked in at less-than-adequate levels. GCI/City Ex. 12.5, attached to GCI's Reply Brief, summarizes each service quality measure and benchmark proposed by GCI, along with the source of the benchmark.

A specific discussion of the proposed measures and benchmarks follows.

a. (POTS) Installation Within 5 days

IBT notes in its Brief that all parties agree that the Installation within 5 Days measure should be retained in the plan. However, the Company takes issue with GCI's and Staff's recommendation that this measure should be clarified to only include POTS installations. As noted above, the inclusion of vertical service installation times within the Company's calculation of this measure effectively masked the Company's poor POTS installation time performance during the life of the existing plan.

IBT argues that because the Company has always included vertical services in its calculation of its performance of this measure, "changing" the definition of the measure without adjusting the benchmark would "in effect, arbitrarily raise the standard of service reflected in the plan." IBT Brief at 70. The Company opines that permitting only POTS installations in the measure would be inconsistent with the goal of maintaining, and not improving service quality. Id. It recommends that if the Commission clarifies the definition of the measure to exclude vertical service requests, then it should apply the 90% benchmark contained in 83 Ill. Admin. Code Part 730 because it would have been unable to achieve that standard had vertical service been excluded from the calculation. Id. at 70-71.

GCI argues that the Company's opposition to clarifying the measure to include the installation of POTS lines only should be rejected for several reasons. First, as Mr. McClerren's testimony makes clear, clarifying this measure to include the installation of POTS lines only would not constitute a change in the definition of the measure. Illinois Bell, unlike any other LEC in the state, inappropriately chose to include vertical services in the computation of this measure, according to GCI. Staff Ex. 8.0 at 9; GCI/City Ex. 2.0 at 27. That decision resulted in the masking of IBT's poor performance with respect to the installation of POTS lines, and the avoidance of a service quality penalty throughout the life of the plan. Staff Ex. 8.0 at 10. Clarifying this standard to ensure that only POTS lines are included within the computation of the Company's performance is necessary to ensure that the company measures its performance the way the Commission intended LECs to measure it.

The Company also argues that because the record doesn't show *exactly* how much the demand for vertical service has grown since the 1990-91 time period (the period used to form the current benchmark), no support exists for Staff's and GCI's view that the standard need not be relaxed if clarified to included POTS installations only. GCI characterizes this point as a strawman argument, and notes that: (1) vertical service "installations" require nothing more than a computer entry by a customer service representative (Tr. 1814-1815), (2) demand for these services has exploded over the course of the plan, particularly since the merger with SBC and the corresponding increase in the marketing of vertical services like Caller ID and others (AI Ex. 8.0 at 8-9, 14-18), and (3) the Company's ability to meet the standard increases dramatically when vertical services are included in the computation (Tr. 1934-1939). Staff could find no other LEC in Illinois that, before or since the plan, has computed this measure by including vertical service requests. Staff Ex. 8.0 at 9. GCI points out that when it set the benchmark at the level the Company was attaining on average for the 1990-1991 time period, the Commission believed in 1994 that the Company was measuring installation of POTS lines only. Id. at 7; Tr. at 1797. There is no evidence that that level was any different from other LECs' performance, suggesting that the effect of including vertical services in the computation at that time was negligible. The Commission, GCI argues, should reject the Company's suggestion that the easier, 90% benchmark – a benchmark level that represents the *minimum* standard for LEC service quality -- is appropriate. The fact that the Company admits it never could have met the existing 95.44% benchmark level during the life of the plan had it excluded vertical services as it should have does not mean the Commission should lower its standards.

Commission Conclusion

The Commission concurs with Staff and GCI that IBT's request to lower the applicable benchmark for the OOS>24 measure or permit the Company to include the "installation" of vertical services in the computation of this standard. In order to clarify once and for all the definition of this measure, the Commission adopts GCI's recommendation to rename this measure "POTS Installations Within 5 Days". Permitting the Company to include vertical services in the measurement of company installation performance effectively masks the Company's failure to install network access lines within 5 days. For all of the reasons stated by GCI and Staff, the Commission rejects the Company's position that vertical services should be included in the measure or that, in the alternative, the applicable benchmark should be lowered.

b. Trouble Reports per 100 Access Lines

All parties support retention of the existing measure and benchmark for Trouble Reports per 100 Access Lines.

c. Out of Service Over 24 Hours

Although all parties favor retention of the OOS>24 measure and the existing benchmark of 5%, GCI witness TerKeurst testified that the Company's current method of computing the measure by including service outages related to "acts of God" (i.e. severe weather) in the denominator but excluding "acts of God" in the numerator effectively underreports the percentage of lines that were out of service for more than 24 hours. GCI Ex. 12.0 at 32-33.

In its Brief, IBT argues that its method of computing the measure is entirely consistent with past practice, and should be retained. IBT Brief at 71. The Company also asserts that excluding "acts of God" from the denominator "would artificially reduce the total number of troubles essentially implying that [the weather-related troubles] did not exist." Id.

GCI responds that IBT's arguments in this regard should be rejected. First, the fact that the Company has been calculating the OOS>24 measure a certain way for a long time is irrelevant if the computation methodology is incorrect or produces misleading figures. Second, mathematically-speaking, GCI submits that there is no doubt that excluding weather-related outages from the numerator, which represents the number of outages that exceeded 24 hours, and then dividing that number by a figure that represents the total of all outages, *including* weather-related outages, decreases the resulting OOS>24 percentage. IBT's methodology is akin to mixing apples with oranges (or dividing apples by oranges), and inappropriately underreports the extent to which the Company failed the OOS benchmark, according to GCI.

GCI further notes that the Company has economic reasons for calculating the OOS>24 measure in the current manner. As noted by IBT witness Hudzik, exclusion in 1999 of lines out of service for more than 24 hours due to "acts of God" from the denominator increases IBT's OOS>24 percentage from 4.76 percent to 5.86 percent, and IBT would have failed the standard for that year. AI Ex. 12.0 at 43.

Commission Conclusion

The Commission concludes that mathematically speaking, there is no doubt that excluding weather-related outages from the numerator, which represents the number of outages that exceeded 24 hours, and then dividing that number by a figure that represents the total of all outages, *including* weather-related outages, decreases the resulting OOS>24 percentage. IBT's methodology is akin to mixing apples with oranges (or dividing apples by oranges), and inappropriately underreports the extent to which the Company failed the OOS benchmark, according to GCI. Accordingly, the Commission adopts GCI witness TerKeurst's recommendation to exclude outages associated with "acts of God" from the denominator, as they are excluded in the numerator.

d. Percent Dial Tone Within Three Seconds

The parties agree that the Percent Dial Tone Within Three Seconds should be eliminated from any alternative regulation plan approved in this docket.

e. Operator Speed of Answer – Intercept

Because technological advances have allowed automation of the operator intercept function, IBT has been able to meet this benchmark with increasing ease. GCI/City Ex. 12.0 at 35. Accordingly, Staff, the Company and GCI agree that this measure can be excluded from any plan adopted in this proceeding.

f. Operator Average Speed of Answer –Toll and Assistance, Information

Currently, Operator Average Speed of Answer – Toll and Assistance has a benchmark of 3.6 seconds, and is measured separately from Operator Average Speed of Answer – Information, which has a benchmark of 5.9 seconds. Both Staff and the Company recommend that these measures be combined and the benchmarks consolidated. While both Staff and the Company agree a weighted average should be used to compute the combined benchmark, the Company calculated it over the 1994-2000 period, to produce a 5.61 second benchmark, with the Staff preferring the use of the 1998-1999 time frame, to produce a 5.65 benchmark. IBT Brief at 73; Staff Brief at 72.

GCI opposes such a consolidation of measures and benchmarks, however, because these parties argue that averaging the operator average speed of answer measures may encourage IBT to increase the time taken to answer toll and assistance calls, which currently have a response time requirement shorter than that imposed on information calls. GCI/City Ex. 12.0 at 35, GCI/City Ex. 12.8E, p. 1. GCI submits that such an outcome would be inconsistent with Section 13-506.1's requirement that any approved plan, at a minimum, improve service quality.

In its Brief, IBT argues that such concern is "speculative", and that any increases in answer times would be reflected in the overall average, "so Ameritech Illinois' ability to prioritize one set of calls over the other would be very limited." IBT Brief at 72.

Commission Conclusion

The Commission rejects IBT's reasoning on this point. Given the Company's service quality performance over the life of the plan, and its admitted inclination to approach service quality performance based on existing financial incentives, it is not unreasonable to anticipate situations that could incite behavior that degrades service quality. Attempting to satisfy the statutory goal of, at a minimum, maintaining service quality by identifying potential areas for relaxed performance, does not constitute speculation. Moreover, it is undeniable from a mathematical perspective that combining the measures and benchmarks permits the Company to permit answer times for Toll and Assistance calls to lengthen.

Accordingly, the Commission adopts GCI's recommendation to retain the Operator Average Speed of Answer – Toll and Assistance, and Operator Average Speed of Answer – Information measures and their corresponding benchmarks as separate service quality criteria.

g. Trunk Groups Below Objective

All parties agree that the Trunk Groups Below Objective can be eliminated from any alternative regulatory plan approved by the Commission.

h. Average Speed of Answer – Residential and Business Customer Call Centers

While the Company, Staff and GCI agree that the answer time for customer call centers should be added into the service quality measures of any approved plan, GCI believes that separate measures should be adopted for the Residential Customer Call Center and the Business Customer Call Center. GCI/City Ex. 2.0 at 39-43.

In opposition to this proposal, the Company argues that creating a separate benchmark for residential and business customer call centers is inconsistent with the manner in which business office answering time is defined in Part 730. IBT Brief at 79. IBT also opines that adopting separate measures would inappropriately over-emphasize answering time in the context of the overall service quality component of any regulatory plan. Id. at 80. The Company suggests that if separate measures are created, the relevant penalty should be split between the two measures. Id.

GCI lists a number of reasons why IBT's complaints in this regard should be rejected. First, IBT processes residential and business customer calls in separate centers. Second, because IBT currently monitors and measures its average speed of answer performance for each type of customers separately, a requirement that the Company report is performance separately for each type of customer group will add no burden to IBT. Third, separating the measures will ensure that the Company does not discriminate in its response time to residential customers when compared to business customers. GCI/City Ex. 12.0 at 37. GCI points out that the Company acknowledged during cross-examination that, from a mathematical standpoint, not disaggregating this measure could result in one customer class receiving significantly different service quality performance from the Company than the other class. Tr. 1839.

Moreover, GCI cites Ms. TerKeurst's testimony, which revealed that the Company's performance has been quite erratic to varying degrees in both the residential and business call centers. For example, its average speed of answer at residential call centers ranged between 51 and 392.1 seconds in 1998, between 31.7 and 413.1 seconds in 1999 and between 32.4 and 118 seconds in 2000 (through August). GCI Ex. 2.0 at 40. Average residential hold times, that is the amount of time the customer spends on hold once the call is answered, ranged between 25.1 and 72.7 seconds between 1998 and 2000. Id. Performance was also erratic, but with faster average speed of answer and longer average hold times, in the business call centers. Average speed of answer in IBT's business call centers ranged between 24 and 114 seconds in 1999, and between 17 and 32 seconds in 2000. Id. Average hold time was not provided for business call centers.

GCI states that it is essential to separate the business and residential call center answering times in order to ensure that the Company does not mask service quality differences between customer classes. GCI states that its proposed separation of the measures also guards against discriminatory behavior favoring business customers. GCI Ex. 12.1 demonstrates that calls to business call centers are currently answered much more promptly than calls to residential centers.

GCI further noted that Ms. TerKeurst testified that IBT's established target for residential customers call centers is 60 seconds. However, the Company's internal target for business call centers is 80% of calls answered within 20 seconds. Ms. TerKeurst recommended that this 80% of calls answered within 20 seconds also be adopted for residential customer call centers. GCI Ex. 2.0 at 39-43.

Staff also proposed that this benchmark be employed, albeit for a combined residential/business customer call measure. In the alternative, Ms. TerKeurst proposed benchmarks of 33.5 seconds for residential call centers and 24.1 seconds for business call centers (updated as appropriate to reflect the yearly average for 2000). GCI/City Ex. 12.0 at 38.

In opposition to GCI's proposed benchmark answer time, the Company notes that it has not consistently met the average of 60 seconds for all calls in Part 730. IBT Brief at 78, 80. IBT further argues that the 80% within 20 seconds standard "lacks either a historical performance record or a Commission rule to support it", and, as such, cannot be deemed to "maintain" any recognized level of performance. IBT Brief at 79.

Commission Conclusion

The Commission adopts GCI's proposal to establish separate measures for the Residential Customer Call Center and the Business Customer Call Center given the erratic, differing answer times between the residential and business customer call centers as described above. Moreover, the Commission agrees with GCI that an assessment of whether IBT's service quality is being maintained should compare its current performance with its performance during years prior to alternative regulation. For service quality measures for which IBT has not provided pre-plan data, such as these measures, the Company should generally be held to meeting either its own internal standard or the performance it achieved during the "best" alternative regulation year for which data is available. Accordingly, the Commission adopts as a benchmark for these two measures the Company's own internal target benchmarks of 80% within 20 seconds for the residential and business customer call centers.

i. Average Speed of Answer – Repair

GCI, Staff and the Company agree that a measure for the Average Speed of Answer for Repair offices should be included in any service quality measure. Staff and the Company propose to set a benchmark for this measure of 60 seconds for all calls. IBT Brief at 78. GCI proposes that the 80% of calls answered within 20 seconds standard proposed for the customer call centers also be used for the repair office measure. The Company opposes this standard for the same reasons it opposed it in the residential and business customer call center measures. Id. at 78- 80.

GCI submits that the problem with Staff's and the Company's support for the 60-second benchmark is that it relies on data taken *during* the price cap plan. This is not an appropriate basis for meeting the statutory standard expressed in Section 13-506.1(b)(6) of determining whether the plan, at a minimum, maintains service quality, according to GCI. Moreover, GCI notes that the Company's complaints that use of internal benchmarks is inappropriate because they are viewed as difficult objectives designed to stretch the capabilities of IBT employees is not persuasive. During cross-examination, the Company admitted that when selecting the benchmarks, the organizations do *not* pick benchmarks that they cannot meet. Tr. 1840. In addition, GCI notes that Company witness Hudzik admitted that IBT has met its own internal service quality benchmarks, and even modified them to a stricter level to inspire improved performance. Tr. 1842, 1856-1858.

Commission Conclusion

The Commission concurs with GCI that the benchmark for the Average Speed of Answer—Repair measure should be set at the GCI-recommended 80% within 20 seconds level. The Commission agrees that the problem with Staff's and the Company's support for the 60-second benchmark is that it relies on data taken *during* the price cap plan. This is not an appropriate basis for meeting the statutory standard expressed in Section 13-506.1(b)(6) of determining whether the plan, at a minimum, maintains service quality. Expecting the Company to achieve its own internal benchmarks for purposes of gauging service quality performance is not unreasonable. Indeed, the Company admitted that when selecting the benchmarks, the organizations do *not* pick benchmarks that they cannot meet. Tr. 1840. In addition, the Commission is persuaded by IBT witness Hudzik's admission that IBT has met its own internal service quality benchmarks, and even modified them to a stricter level to inspire improved performance. Tr. 1842, 1856-1858.

j. Percent of Calls Answered

IBT opposes the inclusion of measures of an abandoned call measure for the residential, business and repair customer call centers. IBT Brief at 81-82. The Company points to the fact that the Commission chose not to include such a measure the last time it modified the Part 730 rules. Id. at 82. The Company also characterizes such a measure as "a less direct and less accurate" measure of answering performance than the average speed of answer measures. Id.

GCI argues in its Reply Brief that these arguments are not persuasive and should be rejected. First, as explained by GCI, this measure would be very useful in identifying any trend in the percent of calls that are abandoned because of excessive delays in response time. Staff witness Cindy Jackson pointed out in testimony that IBT data suggests that an increase in the average speed of answer results in an increase in the percent of calls abandoned by customers. Moreover, GCI notes that Ms. TerKeurst's direct testimony reveals Company data that shows that the percent of calls answered was markedly better for business than residential customer call centers. GCI/City Ex. 2.0 at 45. This phenomenon supports the establishment of separate Percent of Call Answered measures for the residential and business call centers. Measuring such data is equally important for repair call offices, GCI asserts.

Commission Conclusion

The Commission agrees with GCI that the Percent of Call Answered measure provides another indicator of IBT's accessibility and responsiveness to customer inquiries and service needs. Although the Company has a 90% target level as its own internal measure, a 95% level should be established as the benchmark for each of these three measures. As noted by Ms. TerKeurst, IBT has been exceeding the 90% target benchmark. GCI/City Ex. 2.0 at 46. Thus, its use as a standard could result in a degradation of service. Instead, the benchmark should be based on IBT's actual performance to safeguard against erosion of service quality as required by Section 13-506.1(b)(6) of the Act. Moreover, use of such a standard would be consistent with the Commission's rationale for establishing a standard for the Company's % Installation Within 5 Days measure that was above the standard in Part 730 of the Commission's rules. See Alt. Reg. Order at 58.

Accordingly, the Commission adopts a Percent of Call Answered standard, with a benchmark of 95 percent, with performance measured separately for residential, business and repair call centers.

k. POTS Mean Installation Interval

GCI proposes the inclusion of a POTS Mean Installation Interval measure in any plan approved by the Commission. GCI notes that Staff witness Sam McClerren testified that the degree by which the Company misses a service quality benchmark is of concern to the Commission. Tr. 1798. If the Company misses the Installation Within 5 Days benchmark at any given time, the situation can become markedly worse depending on the amount of time beyond the five-day interval customers are forced to wait. GCI points out that currently IBT maintains a POTS Mean Installation Interval that measures the average business days taken to install POTS service only. GCI/City Ex. 2.0 at 47. It also tracks installations for both POTS and other services combined. Id. at 46-47. Financial consequences for failure to meet a POTS Mean Installation Interval benchmark would provide an invaluable safeguard against prolonged delays for installations that take more than 5 days. Such a measure would discourage the Company from moving customers whose POTS has not been installed within 5 days to the bottom of the work queue before service is ultimately installed, according to GCI. GCI Ex. 12.0 at 40. The measure would encourage IBT to install all POTS lines as soon as possible regardless of whether the Installation-Within-5-Days measure had been met. Staff expressed no opposition to the inclusion of this measure in any Commission-approved plan.

In opposition to this proposal, IBT argues that "it has never engaged in the practice that Ms. TerKeurst alleges", and hence suggests that no factual basis exists for adopting the POTS Mean Installation Interval measure. IBT Brief at 82.

GCI responds that this argument should be rejected for a couple of reasons. First, the Company cites no testimony from any Company witness who asserted this has never happened. Second, the record evidence shows and it is common knowledge that many IBT customers were forced to wait weeks last summer for the installation of a POTS line. AI Ex. 12.0 at 9. Accordingly, GCI submits, including a financial incentive that would discourage supervisors from letting customer requests for POTS lines languish in a work queue when it is determined that the Installation Within 5 Days benchmark has not been reached is critical to the maintenance of service quality.

Ms. TerKeurst recommended that a benchmark for this measure be set at four business days. If IBT is supposed to complete 95.44% of installations within five days, it is reasonable that the standard for mean installation intervals would be less than five business days, GCI argued. GCI/City Ex. 2.0 at 48. GCI urges the Commission to adopt this proposed standard and benchmark.

Commission Conclusion

The Commission adopts GCI's proposal to establish a POTS Mean Installation Interval measure. The Commission is believes that the Company must be provided with a financial incentive to not permit installation orders that have not been completed within the five-day benchmark to languish indefinitely. If the Company misses the Installation Within 5 Days benchmark at any given time, the situation can become markedly worse depending on the amount of time beyond the five-day interval customers are forced to wait. IBT maintains a POTS Mean Installation Interval that measures the average business days taken to install POTS service only. It also tracks installations for both POTS and other services combined. Financial consequences for failure to meet a POTS Mean Installation Interval benchmark would provide an invaluable safeguard against prolonged delays for installations that take more than 5 days. Such a measure would discourage the Company from moving customers whose POTS has not been installed within 5 days to the bottom of the work queue before service is ultimately installed, according to GCI.

The Commission further adopts GCI's proposed benchmark of four business days. If IBT is supposed to complete 95.44% of installations within five days, it is reasonable that the standard for mean installation intervals would be less than five business days.

l. POTS Mean Time to Repair

GCI argues that, like the POTS Mean Installation Interval, including the GCI-proposed POTS Mean Time to Repair measure in the service quality component of any alternative regulatory plan would provide the Company with a financial incentive to ensure that service outages that exceed 24 hours are not neglected even longer. GCI/Ex. 12.0 at 41. Currently, IBT measures its POTS Mean Time to Repair, with an internal benchmark of 21 hours. GCI Ex. 2.0 at 49. Ms. TerKeurst testified that there is reason for the Commission to monitor this performance area. The Company's mean time to repair POTS lines has significantly increased from an average of 24.32 hours in 1999 to an average of 40.25 hours in 2000 (through September), with the mean time to repair POTS lines hitting 77.72 hours in September, 2000. Id. at 49-50. Given the Company's poor performance in the POTS Mean Time to Repair area, establishing a target level of 21 hours would encourage improvement and should be adopted.

Again, the Company argues in its Brief that no evidence exists that the Company engaged in behavior wherein outages that were not repaired within 24 hours were put on the backburner. GCI responds that a check of the citations offered as support for this statement in the Company's Brief reveals that no witness ever made such an assessment. The fact is that a financial incentive currently exists, whether it has been acted upon or not, for technician crews to pass over requests for repair if it can be determined that the outage has surpassed the 24-hour mark.

Commission Conclusion

The record evidence shows that the Company's performance in the area of repairing service outages needs to be monitored closely given its abysmal record at satisfying the OOS>24 benchmark. GCI urges the Commission to provide the Company with a financial incentive to restore service as quickly as possible to all customers by including a POTS Mean Time to Repair measure in the service quality component of any alternative regulatory plan approved in this docket.

m. POTS % Repeat Trouble Report Rate

The Company does not object to the inclusion in any plan of a POTS % Repeat Trouble Report Rate, which would measure the percentage of customer trouble reports received within 30 calendar days of a previous customer trouble report. GCI/City Ex. 2.0 at 54. GCI argues that the inclusion of such a measure in any regulatory plan would discourage the Company from prematurely closing out service tickets to avoid the financial consequences associated with failing the %OOS>24 standard, since prematurely closed out service tickets could lead to repeat troubles, which could then be picked up in the POTS % Repeat Trouble Reports measure. GCI/City Ex. 2.0 at 56.

GCI recommends that the Company's internal target level of 10 percent be adopted as a benchmark. The Company provides no argument in its Brief in support of its proposed benchmark of 13.92%, which is based on its average performance during the 1995-1999 time period. It is unclear where the Staff stands with respect to the benchmark level.

GCI offers several reasons why Ms. TerKeurst's proposed 10% level is the better choice for a benchmark. First, the Company's support for the 13.92% benchmark relies on data taken *during* the price cap plan. Given the absence of data preceding 1995, there is no basis upon which one can conclude that the service quality performance by IBT between 1995 and 1999 for this measure is as good as it was prior to the adoption of the price cap plan. GCI maintains that this is not an appropriate basis for meeting the statutory standard expressed in Section 13-506.1(b)(6) of determining whether the plan, at a minimum, maintains service quality. Moreover, GCI argues, the Company's complaints that use of internal benchmarks is inappropriate because they are viewed as difficult objectives designed to stretch the capabilities of IBT employees is not persuasive. Again, as noted above, the Company admitted that when selecting the benchmarks, the organizations do *not* pick benchmarks that they cannot meet. Tr. 1840. In addition, GCI points out that Company witness Hudzik admitted that IBT has met its own internal service quality benchmarks, and even modified them to a stricter level to inspire improved performance. Tr. 1842, 1856-1858.

Commission Conclusion

For all of the reasons offered by GCI, the benchmark for the POTS % Repeat Trouble Report Rate measure should be set at the GCI-recommended 10% level. The Company's support for the 13.92% benchmark relies on data taken *during* the price cap plan. Given the absence of data preceding 1995, there is no basis upon which one can conclude that the service quality performance by IBT between 1995 and 1999 for this measure is as good as it was prior to the adoption of the price cap plan. The Commission agrees with GCI that this is not an appropriate basis for meeting the statutory standard expressed in Section 13-506.1(b)(6) of determining whether the plan, at a minimum, maintains service quality. Moreover, the Commission rejects the Company's complaints that use of internal benchmarks is inappropriate because they are viewed as difficult objectives designed to stretch the capabilities of IBT employees is not persuasive. Again, as noted above, the Company admitted that when selecting the benchmarks, the organizations do *not* pick benchmarks that they cannot meet.

n. POTS % Installation Repeat Trouble Reports (7 Days)

IBT already tracks the percent of new POTS installations that fail or are identified as improperly installed within seven calendar days of installation. GCI/City Ex. 2.0 at 57. This measure is computed as (count of installed POTS trouble rate within 7 calendar days of installation/total POTS installations) x 100. The Company's internal standard is that no more than five percent of POTS installations should experience trouble within seven calendar days. Id.

GCI argues that high installation trouble report rates should not be tolerated. Including a POTS % Installation Repeat Trouble Reports measure in the plan would help ensure that the myriad of new technicians the Company has been hiring (Tr. 1981, 1983-1985) would be trained to install service correctly the first time. GCI/Ex. 2.0 at 53.

In its Brief, the only argument the Company provides against adopting this measure is the statement that it believes such a measure need not be included in the Commission's service quality measures, and that it did not object to adding a measure for % Repeat Trouble Reports because it assumes people might be more sensitive to repair repeats "because they have already experienced one instance of trouble." IBT Brief at 83-84.

Commission Conclusion

IBT's reasoning for objecting to the inclusion of this measure is hardly persuasive. The Commission concurs with GCI witness TerKeurst that customers have continuing concerns regarding the quality of IBT installations. The Company received a mean score of 86.5 points in the Ameritech Illinois Small Business Activation Survey and a mean score of 79.3 points in the Ameritech Illinois Small Business Assurance survey for performing installation work correctly the first time. GCI/City Ex. 2.0 at 53. Moreover, the Company received a mean score of 84.6 points in the Ameritech Illinois Consumer Activation survey and a mean score of 71.2 points in the Ameritech Illinois Consumer Assurance survey for performing installation work correctly the first time. Id.

The Company has maintained a POTS % Installation Trouble Report Rate ranging between 4.13 percent and 4.69 percent between 1998 and September 2000. Accordingly, IBT's internal standard of 5 percent should not be viewed in any way as a "stretch factor". Inclusion of the POTS % Installation Trouble Report Rate Within 7 Days measure with a 5 percent benchmark would help ensure that service quality is maintained (i.e., a reasonable amount of installations are done correctly the first time) on a prospective basis.

Although IBT argues in its Brief that "Ms. TerKeurst's definition of POTS Installation Repeat Troubles is different from the Company's, making its internal performance target, as well as its actual performance, completely inapplicable to the GCI proposal", nowhere in the record – including the testimony IBT cites in its Brief -- is such a statement made.

In addition, the Company argues that it has "changed both the measure and the performance target for installation repeat reports over the years", and that any comparison to either past performance data or internal targets would be suspect. IBT Brief at 84. This argument is likewise suspect. The Company failed to cite any part of the record that shows that the existing measure is somehow different now than it has been in 1999. Ms. TerKeurst's proposed % POTS Installation Repeat Trouble Report Rate measure is based on the measure that the Company uses now. It is adopted, along with the 5 percent benchmark, to help ensure that service quality is maintained under any new regulatory plan.

o. POTS % Missed Installation Commitments – Company Reasons

IBT's existing internal measure of % Missed Installation Commitments Due to Company Reasons measures the percent of new, relocating and change (change in existing service without a move) orders, where installation was not completed by the due date as a result of company action. This measure includes commitments to install both POTS and other services, and is different than a measure of % Missed Installation *Appointments*. The Company established targets of no more than 1 percent of due dates be missed for installations that may or may not require a field visit, and no more than 5 percent of installations requiring field visits be missed. GCI/City Ex. 2.0 at 57. The Company also measures its <u>POTS</u> % Missed Installation Commitments Due to Company Reasons, but did not provide a target for that measure. <u>Id.</u>

GCI, Staff and the Company agree that a measure of missed installation commitments should be included in the plan. The differences in proposals lie primarily in agreeing on a definition for the measure and the appropriate benchmark. In its Brief, the Company argues that if the Commission chooses a measure that would exclude vertical services (i.e. POTS only), it should adopt a benchmark of 90%. IBT Brief at 74.

GCI argues in its Reply Brief that monitoring installation commitment performance for POTS and imposing financial consequences if IBT breaks installation commitments will help ensure that the Company does not divert resources away from POTS installation to other, more elastic services, thereby degrading the quality of services received by POTS customers. GCI/City Ex. 2.0 at 58-59. GCI notes that the Company's own internal data provided support for Ms. TerKeurst's recommendation that the benchmark for % POTS Installation Commitments be set at 1%, IBT's own internal benchmark. Based on data in its NARUC report, IBT's POTS % of Missed Installation Commitments Due to Company Reasons has ranged between about 1.18 percent and 1.72 percent in 2000. <u>Id.</u> at 58.

In response to this proposal, the Company's Brief alleges that Ms. TerKeurst's recommendation to include separate measures for POTS % Missed Installation Commitments and % POTS Missed Installation Appointments is based on a misunderstanding of exactly what the Company's internal benchmarks measure. IBT Brief at 75. IBT asserts that the above-mentioned NARUC data reflect total installation commitments, including those that require field visits and those that do not. IBT Brief at 75. As support for this assertion, the Company cites the surrebuttal testimony of IBT witness Hudzik. A review of that citation, however, reveals that Mr. Hudzik never denied that the Company filed data on <u>POTS</u> % Installation Commitments Due to Company Reasons with NARUC.

The Company then points to IBT witness O'Brien's testimony (AI Ex. 3.2 at 4) as evidence that "[t]he <u>only</u> available data that separately track installation commitments requiring field visits are the data Ameritech Illinois began to provide to Staff in 2000." IBT Brief at 75. A review of that testimony, however, shows it is the *Company* that appears confused. Here, Mr. O'Brien clearly uses the words *commitments* and *appointments* interchangeably. As noted above, this is inappropriate due to the fact that both the GCI and Staff service quality proposals treat these measures separately.

The Company further complains in its Brief that it is inappropriate to adopt an internal benchmark, in this case of 1% each for the POTS % Missed Installation Commitments Due to Company Reasons and for the POTS % Missed Installation Appointments measures, again arguing that internal benchmarks represent "stretch"goals for the Company. IBT Brief at 76. The Company again proposes use of the average performance from the 1995-1999 period, or 2.08% if both field and non-field visit installation data is used, and 10% if the field-visit only installations are incorporated.

As an alternative proposal, Ms. TerKeurst recommended that if the Commission concludes that actual performance should be used for purposes of computing benchmarks, despite the absence of pre-plan data, a benchmark of 1.32 percent should be adopted for POTS % Missed Installation Commitments Due to Company Reasons, based on 1999 performance. GCI/City Ex. 12.0 at 49. In response, the Company objects to the use of a single year's data for determining benchmarks, characterizing it as inappropriate "picking and choosing." IBT Brief at 76. IBT's Brief also cites Company witness Hudzik's vague criticism that the use of the best year fails to account for year-to-year variability in factors such as weather and economic conditions.

Staff's proposes to use a two-year average of 1998 and 1999 Company data for purposes of establishing a benchmark for this measure. It proposes the benchmark be set at 6.2% if the measure incorporates field visit installation performance only and 1.4% if the definition includes both field and non-field installations.

Commission Conclusion

As noted above, the Company admitted during cross-examination that when selecting the benchmarks, the organizations do *not* pick benchmarks that they cannot meet. Tr. 1840. In addition, Company witness Hudzik admitted that IBT has met its own internal service quality benchmarks, and even modified them to a stricter level to inspire improved performance. Tr. 1842, 1856-1858.

While Staff's suggestions for a benchmark for this measure are better than the Company's proposed benchmarks, Ms. TerKeurst's recommended use of the 1999 level best ensures that service quality would be, at a minimum, maintained under the plan.

Accordingly, the Commission adopts Ms. TerKeurst's proposed POTS % Missed Installation Commitments Due to Company Reasons measure and incorporates a 1% benchmark.

p. POTS % Missed Repair Commitments – Company Reasons

The Company does not object to the adoption of a similar measure for POTS % Missed Repair Commitments – Company Reasons, as recommended by GCI and Staff. IBT Brief at 77. However, it takes issue with GCI's proposal to use the 1% internal benchmark the Company adopted for its % Missed Installation Commitments -- Company Reasons measure. Instead, the Company argues a 9.58% benchmark, based on IBT's performance for the years 1995-1999 should be used. Staff supports the use of a 6.4% benchmark, based on the Company's average performance for the 1998-1999 time period.

GCI argues in its Reply Brief that IBT provided no data for this measure for years preceding the adoption of the price cap plan. GCI/City Ex. 12.0 at 50. As a result, the Commission cannot be certain that adoption of a benchmark based on even the best year under alternative regulation will result in the maintenance, as opposed to the degradation, of service quality for this measure. Id. GCI further notes that the Company's internal target of 5% for % Missed Repair Commitments is markedly worse than its established target for % Missed Installation Commitments. This variance in target levels suggests that the Company places a higher priority on installing new service than repairing existing service. GCI/City Ex. 2.0 at 60.

GCI states that the Company's performance data shows its % Missed Repair Commitments Due to Company Reasons increased from 5.21 percent in January of 2000 to 11.99 percent in June of 2000. Id. This stands in sharp contrast to the much lower % Missed Installation Commitment rates just discussed. Id. Adoption of a 1 percent benchmark would ensure that IBT's inadequate performance results in financial consequences that escalate if service quality degrades further, and would help ensure that customers are not left waiting for their service to be repaired, GCI states. IBT itself admits that it has achieved its internal benchmarks in the past.

Commission Conclusion

The Commission notes that IBT provided no data for this measure for years preceding the adoption of the price cap plan. As a result, the Commission cannot be certain that adoption of a benchmark based on even the best year under alternative regulation will result in the maintenance, as opposed to the degradation, of service quality for this measure. Id. The Commission concurs with GCI that the Company's internal target of 5% for % Missed Repair Commitments is markedly worse than its established target for % Missed Installation Commitments. This variance in target levels suggests that the Company places a higher priority on installing new service than repairing existing service.

Because the Company's performance with respect to % Missed Repair Commitments Due to Company Reasons increased from 5.21 percent in January of 2000 to 11.99 percent in June of 2000, and stands in sharp contrast to the much lower % Missed Installation Commitment rates just discussed. Adoption of a 1 percent benchmark would ensure that IBT's inadequate performance results in financial consequences that escalate if service quality degrades further, and would help ensure that customers are not left waiting for their service to be repaired.

q. POTS % Missed Installation Appointments – Company Reasons

The Company currently measures the percent of POTS installation appointments missed by IBT due to errors in scheduling, heavy work load or other Company reasons. GCI/City Ex. 2.0 at 61. This measure is computed as (POTS installation appointments missed by IBT due to Company reasons/ total POTS installation appointments) x 100. Id. at 62. GCI argues that inclusion of this measure in any service quality index approved in this docket, with associated financial consequences for violation of a reasonable standard, would help ensure that customers are not left waiting for installation appointments. Id.

In response to discovery, the Company indicated that it employed a 1 percent internal target for this measure. Id. This should be established as the benchmark for this measure. This is a reasonable benchmark given the Company's performance for this measure, which was 0.91 percent in 1998, 0.81 percent in 1999 and 1.10 percent in 2000 (through September). GCI/City Ex. 12.0 at 49.

Commission Conclusion

The Commission rejects the Company's objections to inclusion of this standard in any index and the proposed benchmark, which are the same as IBT stated in its objections to the POTS % Missed Installation Commitments, for the reasons stated above. The Commission concurs with GCI that the establishment of a 1 percent benchmark is a reasonable level given the Company's performance for this measure during the last three years.

r. POTS % Missed Repair Appointments – Company Reasons

Currently, IBT tracks the percent of POTS repair appointments missed by IBT due to errors in scheduling, heavy work load or other Company reasons. This measure is computed as (POTS repair appointments missed by IBT due to Company reasons/total POTS repair appointments) x 100. The Company's internal standard is that no more than 5 percent of POTS repair appointments should be missed for Company reasons. GCI/City Ex. 2.0 at 63.

The Company does not appear to address this issue in its Brief. GCI pointed out that the record evidence shows that IBT's performance with respect to this measure has been deficient. IBT missed 5.56 percent of POTS repair appointments in 1998, with 10.39 percent missed in 2000 (through September, with 15.55 missed during September 2000 itself). GCI/City Ex. 12.0 at 52. The Company acknowledged that it has failed to notify customers when appointments will be missed. Id. ; AI Ex. 12.0 at 10. GCI asserts that adoption of the 1 percent benchmark would ensure that IBT's inadequate performance results in financial consequences that escalate if service quality degrades further and would help ensure that customers are not left waiting for repair appointments that are missed.

Commission Conclusion

The Commission agrees with GCI that a separate measure for POTS % Missed Repair Appointments – Company Reasons should be included in the plan. The record evidence shows that the Company's performance with respect to this measure has been deficient over the last three years. We adopt the 1 percent benchmark proposed by GCI witness TerKeurst in order to ensure that IBT's inadequate performance results in financial consequences that escalate if service quality degrades further and would help ensure that customers are not left waiting for repair appointments that are missed.

* * * *

In sum then, the Commission adopts for inclusion in the regulatory plan approved in this docket GCI's proposals to expand the number of measurements analyzed by the Commission, modify the existing definitions of Installation Within 5 Days Measure and order IBT to recalculate on a going-forward basis its method of computing the number of service outages restored within 24 hours. The Commission also adopts the specific penalty levels proposed by GCI witness TerKeurst.

C. Service Quality Penalty Provisions

IBT proposes that only one change be made in the existing plan's penalty structure: a modification to adjust the PCI back upward when IBT subsequently achieves a benchmark it already missed. IBT Brief at 84.

In response to this proposal, both Staff and GCI assert that the record evidence is clear – the existing penalty structure has proven to be woefully inadequate in inciting the Company to maintain service quality under the plan. Accordingly, GCI argues, the Company's request to not only retain the existing service quality penalty structure, but also permit it to recoup lost revenues once service quality is improved should be rejected.

Both Staff and GCI agree that in order to incite IBT to, at a minimum, maintain service quality at pre-plan levels, the penalty structure must be removed from the PCI. In addition, the financial penalties associated with missing a benchmark must be strengthened. Finally, the disbursement of service quality penalties must be more customer-specific, Staff and GCI argue in their Briefs.

1. The Service Quality Penalty Structure

Staff and GCI agree that, in addition to producing penalties that are too small to inspire IBT to address service quality problems, the current –0.25 penalty factor is deficient because as the Company reclassifies noncompetitive services and the noncompetitive revenue base shrinks, the amount of penalty produced when a benchmark is missed decreases. Staff Brief at 69, 73. Accordingly, the service quality incentive declines with each reclassification. When the price cap plan first began, the –0.25 factor produced a penalty of about $4 million per missed benchmark. GCI/City Ex. 2.0 at 66. Now, this same factor results in a penalty of only $2.6 million. Id.

As evidenced by the Company's failure to meet the OOS>24 benchmark, and the precipitous decline in IBT's performance in this area during 2000, GCI argues that this $2.6 million amount is hardly enough to inspire the Company to make the kind of investment it needs to make to fix its inability to restore service outages on a timely basis. To a Company taking in more than $3 billion in revenues (see AI Ex. 7.2 (Dominak), p. 1), $2.6 million is a proverbial drop-in-the-bucket. As noted in CUB's and the AG's Initial Briefs, the Company admitted during the SBC/Ameritech Merger proceeding (Docket No. 98-0555) that it costs the Company less to pay the service quality penalty adjustment than to invest the $30 million IBT estimates is needed to correct problems associated with meeting the OOS>24 measure. Docket No. 98-0555, Order of October 8, 1999 at 23, citing Tr. 817. Indeed, since the inception of the Plan, IBT has paid only about $29.5 million in cumulative service quality penalties and the OOS>24 benchmark remains unmet for the year 2000. See GCI Ex. 6.5, Schedule E-8 Revised; Staff Ex. 8.0 at 12. GCI points out that even the ICC's decision to assess IBT an additional $30 million penalty for failure to achieve the OOS>24 benchmark in the year after the SBC/Ameritech merger was approved has not been enough to inspire improvement with respect to this measure. For the month of September, 2000, the Company reported an OOS>24 rate of 37.0%, more than seven times the benchmark level and the Company's worst monthly performance under the plan. Staff Ex. 8.0 at 6.

Staff also notes that another problem with retaining the service quality component in the PCI is that it provides no incentive to the Company to improve performance once a benchmark is missed. Staff Brief at 69. Staff observes, that currently, "if the company is going to miss the target, it may as well miss it by a mile, if it is going to miss it by an inch." Id.

GCI's proposes to remove the service quality penalty from the PCI and assess a $12 million penalty per violation. GCI/City Ex. 2.0 at 70. Further, GCI argues that the adjustment should be increased depending on (1) whether more than one violation has occurred, (2) the severity of the violation, and (3) whether there are violations in prior years. By escalating the adjustment, the Company would eventually view the penalties as large enough to motivate it to correct service quality problems. Id. at 68. Moreover, by removing the penalty provision from the PCI, GCI states that penalty amounts assessed are unaffected by IBT's reclassification of noncompetitive services. A detailed discussion of GCI's proposed penalty structure is included in GCI/City Ex. 2.0 at 65-76.

Staff proposes individual customer-specific remedies, as discussed below, for the Installation within 5 Days and OOS>24 measures, and a $25 credit for missed installation and repair appointments due to the Company's fault and without 24-hours notice to the affected customer. For all remaining Staff-proposed service quality measures, customers would receive a $2.25 credit on the monthly bill for each standard and each month the standard is missed.

Should the Commission conclude that the service quality adjustment should remain within the price cap index, both Staff and GCI argue that the Commission must insure that the adjustment provides sufficient incentive to improve and maintain service quality, similar to the proposed out-of-plan penalty provision proposed by GCI.

In order for the service quality adjustment to the Price Cap Index (PCI) to be effective, GCI argues that it must be substantially more than the current .25% adjustment. By increasing the adjustment to 1.25%, the Commission would require the Company to reduce rates by $13 million per violation, which is slightly more than has been proposed for the adjustment outside the PCI. GCI Ex. 2.0 at 76. Similar escalations for severity of the service quality degradation, repeated and multiple violations to those proposed for adjustments outside the PCI should also be added to the formula. The formulas for these escalations, along with examples of calculations, can be found in GCI Ex. 2.0, pages 77 – 78.

In addition, GCI argues that the Commission should reject the Company's request to adjust the PCI back upward if the Company subsequently achieves a benchmark it already missed. The Commission determined in the last price cap Order that no such provision was appropriate if service quality, at a minimum, was to be maintained. The Company's decline in service quality performance during the life of the plan does not justify such a change. Indeed, given the Company's strict adherence to "economically rational" behavior when it comes to service quality, the promise that a revenue reduction might be undone in a coming year decreases the incentive to provide service quality at acceptable levels.

Staff's proposal for an inside-the-plan service quality component retains the 0.25 penalty percentage for all service quality measures, and increases the PCI-related reduction for the OOS>24 and POTS % Installation Within 5 Days measures to 2 percent per year, with no escalation provision. Staff Brief at 79. Staff also proposes that the PCI be adjusted to its pre-penalty level if the Company achieves a previously missed benchmark for 12 consecutive months. Id.

In its Reply Brief, GCI argues that Staff's "within-the-index" proposal is deficient for a couple of reasons. First, contrary to Staff's assessment, increasing the OOS and installation measures to 2 percent, without any escalation for the degree of a benchmark miss, would only create a penalty of $20.8 million rather than the $32 million cited in Ms. Jackson's testimony, due to the reduction of noncompetitive service revenues resulting from IBT's reclassification of services. Staff Ex. 9.0 at 42. GCI notes that even the threat of a $30 million penalty as a result of the Merger Order for noncompliance with the OOS>24 benchmark was not enough to incite the Company to fix its service quality failings. Thus, $20.8 million is unlikely to trigger any change in IBT's behavior.

Second, GCI argues that use of disparate penalty percentage levels may give IBT the incentive to prioritize its service quality performance. Ms. TerKeurst's proposed escalating mechanism, in contrast, would help ensure that the Company viewed each measure as important, according to GCI. Finally, the Staff proposal to re-adjust the PCI, similar to IBT's proposal, effectively negates the incentives provided by the penalty mechanism, and should be rejected.

In response to GCI's penalty proposals, the Company argues that the GCI plan "would result in annual penalties of hundreds of millions of dollars annually…even if service quality were maintained at excellent levels." IBT Brief at 87. IBT notes that its own analysis of applying GCI's proposed penalty structure led to a penalty of $288 million in the first year. Id.

In reply, GCI argues that this assessment should be rejected for a couple of reasons. First, for purposes of its analysis, the Company assumed it service quality performance for all of the measures proposed by GCI as occurred in 1999. While the Company labels it performance for that year as excellent, in fact it was not, as its own Exhibit 12.12 shows. Second, the Company's calculation presumes noncompliance with these missed benchmarks. As Ms. TerKeurst testified, several of the benchmarks she is proposing are based on service quality performance achieved by IBT since inception of the plan. GCI/City Ex. 12.0 at 63. The remaining benchmarks are based on IBT's own internal targets, whose achievement would bring the service quality performance to acceptable levels. Id.

As for the amount assessed, GCI points out that the Company itself admitted that it would take an investment of about $200 million per year to improve IBT's service quality to acceptable levels. Id. at 63-64. As noted above, the Company's track record with respect to the OOS>24 standard confirms that unless financial penalties are greater than the cost of improving substandard service, the Company will choose to pay the penalty in lieu of improving service quality. Id. at 64. Accordingly, the threat of significant penalties is in order, according to GCI. Finally, as Ms. TerKeurst noted, the whole point of the service quality penalty mechanism is to incite the Company to, at a minimum, maintain service quality. GCI notes that when determining what financial incentives to include in any plan, the Commission should consider their likelihood to deter selective service quality degradation, not just their financial impact on the Company. If the Company chooses to make the investments necessary to improve its current service quality performance, the magnitude of the financial penalties associated with missing benchmarks becomes moot because no financial consequences would be incurred. Id.

Commission Analysis and Conclusion

Although we recognized in the last Price Cap Order the incentives inherent in price cap regulation to allow service quality to degrade, the penalty mechanism as it turns out was not sufficient as an incentive to maintain service quality under the plan. Ameritech Illinois has responded to the price cap incentives by trimming its payroll and reducing expenditures, as evidenced, for example, by both its reductions of the number of employees per access line and its expenditures per access line.[2] These reductions in investment and expenses have manifested themselves in the significant declines in critical service quality areas discussed above.

The Commission agrees with GCI and Staff that the service quality penalty provision must be strengthened, include an escalation factor and be disassociated with the level of noncompetitive service revenues if IBT's substandard performance is to improve. IBT's service quality performance with respect to the OOS>24 Hours standard suggests that the current $2.6 million penalty level is woefully inadequate to inspire improved performance on the Company's part. Removal of the penalty mechanism from the price cap plan will ensure that the level of penalty dollars remains high enough to incite the Company to perform at its best ability no matter how many noncompetitive services are reclassified as competitive.

[2] Ameritech Illinois Ex. 1.1 at 32-33.

Our aim is to promote efficient investment in compliance. In other words, if service quality failure is a manpower problem, AI needs to ensure that its employee levels are sufficient to meet workload demands. If there are network deficiencies, AI must invest the necessary funds to correct any ill-functioning systems. In each instance, an expenditure of monies is at the heart of the solution. The choice we provide to the Company is whether it will spend the amounts required to maintain service at reasonable levels or whether it will forfeit the money in credits to customers.

It is the primary recommendation of both Staff and the GCI/City that the Commission remove the Q factor from the Price Index formula. We agree with those proposals. Further, the Commission is interested in moving the credits to those customers directly affected by service quality failures to the extent possible. In addition, to the escalating, out-of-the-formula penalty structure adopted, we also believe individual customer compensation is appropriate in certain instances. In examining our work so far, we have adopted a number of performance measures and annual benchmarks have been set. This done, we believe it appropriate to impose penalties on annual basis..

Generally, penalties are paid to a single entity, and usually in one set amount. Under the current proposals, penalties would be distributed as credits to customers. The reality is that all the proposals are forms of compensation. We first resolve the question as to who should be the recipient of the penalty credits.

We recognize that the standards of service are not all equal. Both Staff and the GCI/City tell us that Installation and Repair are the main components of telephone service. Indeed, Staff singles out these measures as worthy of enhanced penalties and attention under both of its proposals. Notably, AI informs us that it is possible to maintain records of the customers affected by installation and repair delays and by missed installation and repair appointments. On this basis, it is reasonable to distribute credits for these particular infractions to the actual aggrieved parties. This will be done.

To the individual customer, service quality matters a great deal. Moreover, as the Company keeps track of its affected customers, it will be constantly reminded of the risk of penalty if it cannot meet the annual benchmark. We hope this is an incentive for the Company to improve performance in months to come.

With respect to the Company’s failure to meet the benchmarks on other measures are here aggrieved customers cannot be easily tracked, the penalty credits would be distributed among all of AI’s noncompetitive customers. The question remains whether the per aggrieved customer amount reasonably approximates the value of service denied or whether it meets Staff’s concern that it be meaningful. To the extent that only affected customers, suffering the worst inconvenience share in the penalty, it is more likely than not that the credits will be meaningful as well as equitable. Those customers that are less inconvenienced will reap lesser credits and that, too, is altogether reasonable.

We are lead to the ultimate question, i.e., what is to be the penalty for the infraction. The penalty incentive for violations of a particular standard in our view should, at the very least, equal the amount of money to be spent on compliance efforts in order to signal the importance of the obligation and the seriousness by which it should be perceived. After much thought and full review of the proposals before us, the Commission settles on a penalty structure that is reasonable, realistic and geared to send the right signal on compliance.

We will set an amount of $8 million for each failure to meet the “annual” benchmark. This amount will rise by another $2 million each year of the plan. Our starting level recognizes that the oft-cited $4 million penalty in the Plan’s initial term was not meaningful enough and thus, must at least be doubled. The escalation in penalties gives the Company the notice and opportunity to make the necessary investments where and how needed beginning today so that it can avoid the risk of non-compliance, i.e. the penalty.

Penalty Illustration

Year 2001	$ 8 million
Year 2002	$10 million
Year 2003	$12 million
Year 2004	$14 million
Year 2005	$16 million

In addition, if a particular benchmark is not met by more than 5%, or if the same benchmark was also not met in a previous year, an additional $2 million will be added. Further, if a benchmark is not met by more than 10%, still another 2 million will be added.

To be clear, the $30 million penalty imposed by the Commision in the Merger Order was *in addition to* any penalty imposed through alternative regulation. The OSS>24 hrs. performance measure is a special case. It has, and continues to warrant special attention. Hence, in addition to the penalty incentive outlined above for missed benchmarks, IBT will continue to be assessed the $30 million amount originally set in the merger Order, Docket 98-0555.

That said, we cannot discount the possibility of situations so egregious that even this benchmark irregularity will need to be tolerated. Thus, in instances where a customer waits for installation more than 2 extra days or is out-of-service for 48 hours or more, we direct Ameritech to provide on the next bill, the customer credits as specified in its proposal, to wit:

For 00S>24 misses:

(1) OOS reports lasting from 48 hours to 72 hours: a credit equal to one-third of the customer's monthly regulated service

(2) OOS reports lasting 72 hours to 96 hours: a credit equal to two-thirds of the customer's monthly regulated service

(3) OOS reports lasting in excess of 96 hours: a credit equal to one month of the customer's regulated service

For Installation Within Five Days misses:

(1) Installations completed within six to nine business days: One-half of the non-recurring installation charges associated with the order

(2) Installations completed in 10 or more business days: 100% of the non-recurring installation charges associated with the order

The Commission also agrees with GCI's assessment that the Company's customer-specific compensation proposals are both inadequate and confusing. Staff's proposal for IBT to provide a $25 credit to customers for missed appointments doesn't adequately compensate individuals who have stayed home from work waiting for IBT technicians to arrive. The Commission agrees with GCI that this credit should be increased to $50, as proposed by Ms. TerKeurst.

In addition to providing the above direct consumer compensation, the Commision adopts the GCI/City proposal that IBT be ordered to establish a cellular telephone loaner program, so people who are without service can have telephone service available to them while they await installation or repair. Because so many CLECs are resellers, they are still dependent on IBT for basic service connections and some repairs. It is therefore crucial that this program be available to wholesale as well as retail customers, so IBT does not use it to obtain a competitive advantage over CLECs.

These additional direct customer compensation measures are necessary to insure that the people inconvenienced by service quality degradation are compensated for the time they spend without telephone service, for the time and money they lose waiting for technicians who never appear, for the money they lose by having to obtain replacement service, for the money lost from missing work days or business calls, and for the increased risk associated with being unreachable when medical and other emergencies arise.

In addition, to the extent that alternative regulation is designed to foster a transition to a more competitive environment, the Commission must recognize that the issue of whether potential competitors, who must purchase network elements and other services from the incumbent carrier, receive adequate service from the monopoly carriers is relevant. As GCI/City noted in its Briefs, consumers of wholesale services, such as CLECs who provide local service through resale or UNEs, should also be entitled to compensation. Otherwise IBT consumers would receive compensation for poor quality service, but CLECs and their customers would not receive equal treatment. This could have the unintended consequence of further degrading services to CLECs, and undermining the growth of competition, because IBT may give higher priority to consumers for whom it is obligated to pay compensation than to CLEC customers.

All of the above-cited penalties are designed to, ensure that the plan approved in this docket "at a minimum…will maintain the quality and availability of telecommunications services.

IX. EARNINGS ANALYSIS

As noted above, CUB, the City of Chicago, the Illinois Attorney General's Office and the Cook County State's Attorney retained Ralph C. Smith, a regulatory accountant with extensive experience in analyzing telecommunications financial operations[1], to examine the Company's 1999 jurisdictional rate base and operating income statement. After reviewing all of the data provided by the Company in testimony, exhibits, and responses to scores of data requests propounded by both GCI/Cityand the Commission Staff, Mr. Smith concluded that the Company is earnings a 43.08 percent return on equity for intrastate operations and a 28.49 percent return on intrastate rate base. GCI/City Ex. 6.2 at 3. His review of the Company's intrastate revenue requirement shows an Illinois intrastate revenue excess of $956 million, as shown on GCI/CityEx. 6.3, Schedule A Revised, and the need to reinitialize rates prior to the establishment of any kind of going-forward regulatory plan. Staff's own accountants likewise concurred that AI's earnings exceed Staff's computation of a reasonable return on capital, having computed a revenue excess of $824 million for the 1999 test year based on a 10.52% return on rate base. Staff Ex. 30.0 at 4. Staff's accountants likewise determined that the Company is significantly overearning, finding that the Company's earned return on equity amounted to 40.09% (Staff Ex. 30.0, Schedule 30.01). It should be noted that even the Company's own calculation of its adjusted net operating income and adjusted intrastate rate base for the

[1] For a more detailed discussion of Mr. Smith's credentials, see GCI/City Ex. 6.0, Appendix RCS-1.

1999 test year, which do not incorporate any of the operating income and rate base adjustments recommended by either Mr. Smith or the Staff witnesses, reveals an intrastate revenue excess of $276 million. GCI/CityEx. 6.5, Schedule A Revised. Clearly, a significant rate reduction for the Company's going-forward rates is in order.

A detailed discussion of each of the proposed adjustments follows.

A. Revenue and Expense Adjustments

Directory Revenues

Aside from GCI/City's proposed adjustment to the Company's proposed test year level of depreciation expense, GCI/City's recommended imputation of $126 million in directory revenues is the most significant adjustment to the Company's operating income statement. Staff also recommended that directory revenues in the amount of $126 million be imputed to the Company's test year revenue levels. Staff Ex. 7.0 at 4. In the last Alt. Reg. Order, the Commission likewise ruled that a $126 million revenue imputation was necessary for the purpose of establishing an appropriate revenue requirement. Alt. Reg. Order at 101. IBT appealed that Commission finding and lost. Illinois Bell Telephone Company v. ICC, 669 N.E. 2d 919 (2d Dist. 1996) See unpublished portion of decision, slip op. at 29-37, attached to GCI/City Ex. 6.2 as GCI/City Ex. 6.4.

GCI/City note that traditionally, in determining AI's intrastate revenue requirement, Yellow Page profits have been reflected as a contribution toward, or offset to, the cost of local telephone service. This has been the case in order to recognize the diversion of directory revenues away from the local, regulated telephone company and into an affiliate publishing company. The imputation of directory revenues recognizes, in effect, the payment of a royalty fee by the affiliated publisher of the directories – in this case, Ameritech Publishing Inc. ("API") -- to the local telephone company in recognition of the fact that but for the decision of the corporate parent Ameritech to funnel the directory publishing business into an affiliated company, the regulated local telephone company would be realizing the considerable revenues associated with this lucrative business.

GCI/City point out that in the 1994 Price Cap Order, the Commission concluded that a revenue imputation of directory revenues was necessary. In doing so, the Commission noted:

> Under Section 7-102(2) of the Public Utilities Act (PUA), the Commission has jurisdiction over affiliated interests having transactions with public utilities under

the Commission's jurisdiction. API is an affiliate of IBT.

> The Commission has always included revenues from IBT's Yellow Pages advertising in the calculation of the Company's revenue requirements. The issue before the Commission is to determine the appropriate amount of revenues from Yellow pages advertising that will count against IBT's revenue requirements.

Price Cap Order at 101. In that proceeding, the Commission reflected $126 million annually for directory revenue in deriving IBT's intrastate revenue requirement. The $126 million is comprised of the $75 million annually that IBT was receiving from an affiliate, Ameritech Publishing Inc. (API), plus an additional imputation of $51 million, based on a Staff adjustment that the Commission found to be reasonable. The Commission took into consideration the sizeable growth in the revenues from publishing Yellow Pages in Illinois, and concluded that because Illinois Bell did not participate in contract negotiations that affected the amount of revenue it would receive from the affiliate, it missed an opportunity to increase its revenues. Price Cap Order at 97. The Commission specifically concluded that "(b)y diverting the contract revenues from IBT to API, Ameritech shareholders received a windfall by not having the revenues count towards IBT's revenue requirements." Price Cap Order at 101.

This decision was upheld by the Illinois Appellate Court, which noted that the issue of imputing directory revenues implicates two sections of the Act: Section 7-102, which specifies a variety of intercorporate transactions requiring either Commission approval or waiver of approval; and Section 7-102(c), which bars a public utility from disposing of or encumbering any asset. The Court noted that "(a)n asset disposed of or encumbered for less than it is actually worth will increase a utility's revenue requirement and, in turn, its rates." <u>Illinois Bell Telephone Company v. Ill. Commerce Commission</u>, slip op. of July 17, 1996, attached as GCI/Ex. 6.4.

In addition, the Court cited Section 7-203 of the Act, which prohibits the transfer of any "franchise, license, permit or right to own, operate, manage or control" of any utility property without Commission approval, and construed it to prohibit unauthorized, incremental, as well as complete transferal of management authority. <u>Id.</u> The Court concluded that "to hold otherwise would permit utilities to do piecemeal that which they cannot do <u>in toto:</u> transfer control of a public utility to an unregulated entity. <u>Id.</u> Finally, the Court held that unless the Staff-proposed directory revenue imputation adjustment was upheld, "ratepayer would be forced to bear the burden of an increased revenue requirement caused by Bell's foregoing an opportunity to increase directory revenues …" <u>Id.</u>

Both Mr. Smith and Staff witness Mary Everson concur that an adjustment is necessary in the instant proceeding to reflect the appropriate level of directory revenues that is to be applied against IBT's intrastate revenue requirement. GCI/City Ex. 6.0 at 20, Staff Ex. 7.0 at 4.

GCI/City argue that just as was the case in the 1994 docket, a similar issue of diversion of directory revenue is occurring in the current proceeding. Ameritech Illinois admits that an affiliate, API, is publishing Yellow Pages Directories in Illinois and obtaining revenue from such activities. In its 1999 operating income statement filed in this docket, Ameritech Illinois has again attempted to divert all such revenue to API, so that none of it is reflected in assessing the intrastate revenue requirement for AI, the regulated monopoly telephone company. Determining the amount of revenue from directory advertising which should count toward IBT's intrastate revenue requirement therefore is a critical issue in determining the Company's revenue requirement.

GCI/City point out that a few things have changed since the original Price Cap proceeding, and some have remained the same. The directory contract between IBT and its affiliates, API and DonTech[1], (i.e., the contract addressed in Docket No. 92-0488/93-0239) expired on December 31, 1999 and has not been renewed. In 1996, Congress passed the Telecommunications Act of 1996 ("TA 96"), which includes a provision (Section 222(e)) that requires IBT to provide non-affiliated directory publishers with listing information in a fair, impartial and nondiscriminatory manner, and limits IBT to charging such publishers $0.04 per directory listing and $0.06 per listing for updates. GCI/City note that this provision of TA 96 does *not* prohibit telephone companies from publishing directories or selling advertising in such directories. Nor does it prohibit state regulatory commissions from using directory revenues in determining the intrastate revenue requirement for the telephone company. Entities within the Ameritech (now SBC/Ameritech) corporate group have continued to publish and distribute directories in Illinois and to realize substantial revenues from directory operations. Finally, it appears that the revenues being realized from the publication of such directories have increased substantially. GCI/City Ex. 6.0 at 22-23.

In its 1999 operating income statement submitted in this docket, the Company reflected an adjustment to remove the $75 million of directory revenue that IBT was receiving annually from API. See AI Exhibit 7.0, Schedule 1 (Dominak), Column H.[2] This purportedly relates to the expiration as of December 31, 1999 of the directory

[1] The publishing relationship among the various Ameritech affiliates and the Reuben H. Donnelly Corporation can be described as follows: Donnelley has been publishing the Yellow Pages telephone directories for more than 100 years. Ameritech is the unregulated holding company holding all of AI's stock. API is a wholly-owned subsidiary of Ameritech created to compete with Donnelley by publishing a separate Yellow Pages directory. Both Am-Don and DonTech are separate partnerships API and Donnelley entered into for the purpose of publishing a combined Yellow and white pages directory. See GCI/City Ex. 6.4, at 1.

[2] There are some other items added to and netted against the $75 million to produce the $72.770 million reflected on Ameritech Illinois Exhibit 7.0, Schedule 1, Column H.

publishing contract which was discussed in the Commission's 1994 Price Cap Order, and which provided AI with $75 million per year as a guaranteed payment from API. This $75 million amount is separate and apart from revenues paid by API to Ameritech Illinois for listing and billing and collection services.

The Company indicated that it intended to "correct" the $72.270 million intrastate revenue reduction on Ameritech Illinois Exhibit 7.0, Schedule 1, Column H, to $76.449 million to reflect the additional removal of $3.679 million of listing services revenue. The Company's total adjustment removes about $78.7 million of director revenue, and replaces it with about $2.2 million for listing and billing and collection service, per a "prevailing price valuation standard."
Id. at 23.

GCI/City argue that the Company's adjustment has the result of shifting the directory revenue out of AI and into the affiliate API. As a result of this treatment, AI's directory revenues decrease, and API's expenses decrease. For example, ceasing the $75 million annual payment from API to Ameritech Illinois decreases AI's revenue and decreases API expense by this amount. This increases API's operating income before income taxes by $75 million. Id. at 24, citing response to CUB data request 5.24. Thus, income is shifted away from Ameritech Illinois, the regulated telephone company, and into API, the nonregulated affiliate.

The issues concerning directory revenue in this case are: how much is the Ameritech corporate group receiving for the publishing and selling advertising in Illinois directories, and how much of such revenues and directory profits should be allocated to AI, the regulated telephone company, and reflected in AI's revenue requirement determination?

In the instant case, Ameritech is not arguing that IBT could not be the entity publishing the directories and reaping the Yellow Pages advertising revenue. Rather, GCI/City state, in its current attempt to divert directory revenues away from AI and not have such revenues count against IBT's revenue requirement, Ameritech corporate management apparently made a decision to have a nonregulated affiliate, API, rather than Ameritech Illinois, the regulated telephone company, publish the directories. Just as the Commission concluded in the 1994 Price Cap Order, the issue before the Commission is to determine the appropriate amount of revenues from Yellow Pages advertising that will count against IBT's revenue requirements. Price Cap Order at 101.

In response to Mr. Smith's and Staff's proposed adjustment, the Company contends that because the 1984 contract between API and AI expired in 1999 and has not been renewed, that any imputation of directory revenues is no longer relevant. AI Ex. 1.1 at 110. The Company also argues that because Section 222(e) of TA 96 requires ILECs to charge any publisher no more than $0.04 per directory listing and $0.06 per listing for updates, no additional revenues can be imputed. Id. at 111.

GCI/City respond that these arguments are nothing more than red herrings, and should be rejected. First, the fact that AI allowed the contract to expire doesn't change the fact that an affiliate of Ameritech Illinois is reaping hundreds of millions of dollars in profits as a result of Ameritech's decision to permit an affiliate to publish the directories and receive the revenues associated with that activity, thereby shifting directory revenue away from the regulated utility. Moreover, while the TA of 1996 prohibit AI from offering listing and billing and collection services on a preferential basis as it did for years under the old directory contract, that is a different issue from whether directory revenues are being improperly diverted to an unregulated affiliate to the detriment of the ratepayers of the regulated telephone company. GCI/City point out that as recently as July of 2000, the Washington Utilities and Transportation Commission issued a decision denying US West's request to end the Commission's practice of imputing to US West for ratemaking purposes certain "excess" income earned by an affiliate in publishing directories of US West subscribers and associated Yellow Pages commercial classified listings. <u>In Re the Petition of US West Communications, Inc. for an Accounting Order</u>, Docket UT-980948, July, 2000. The appropriate amount of revenues from Yellow Pages advertising that will count against IBT's revenue requirements is an issue in this case.

As shown on Schedule E Revised and Schedule E-1 Revised, page 1, GCI/City urge the Commission to adopt the recommendation of Mr. Smith and impute $126 million or more in Directory Revenue into AI's operating income statement for the 1999 test year and for purposes of determining the Company's revenue requirement on a going-forward basis. GCI/City Ex. 6.2 at 31. This $126 million is the amount used by the Commission in the prior AI case, Docket No. 92-0448, and the amount Staff likewise recommends be imputed. Staff Ex. 32 at 2-4. As demonstrated in Mr. Smith's testimony and exhibits, the $126 million is the minimum amount of directory revenue that should be imputed. Mr. Smith testified, and demonstrated in his Revised Schedule E-1 and E-1.1, that the imputed amount could be as much as $144 million. GCI/City Ex. 6.2 at 31, GCI/City Ex. 6.5, Schedules E-1 and E-1.1.

To illustrate how lucrative the Yellow Pages business can be, and to understand the financial consequences to the regulated phone company when it foregoes the imputation of revenues, GCI/City writes in its Brief that an examination of the Yellow Pages advertiser billings collected by Ameritech Illinois for API as its billing and collection agent, is insightful. The money to be made by a Company that publishes telephone directories is indeed significant. According to AI witness Dominak's rebuttal testimony (IBT Ex.7.1, p.45), the actual amount billed for API Yellow Pages advertising by AI for 1999 was $391 million. Mr. Smith also provided proprietary financial data for Ameritech Publishing of Illinois Inc. (APII) financial statement that underscores the lucrative nature of this business. See GCI/City Ex. 6.2 at 33. On Schedule E-1 Revised, page 3 of 4, Mr. Smith used these amounts of 1999 Directory Revenue, and applied the 36.2% factor used by Staff in the prior case, to derive the level of Directory Revenue imputation pursuant to this calculation method. These proprietary figures are listed at page 33 of GCI/City Ex. 6.2 (Smith Rebuttal). Mr. Smith further testified that the information shown in Table B-10 of FCC Report 43-02 and in a reconciliation of such information subsequently provided by IBT, indicates that the Illinois Yellow Pages revenues are flowing into (and out of) IBT. IBT is billing, collecting and remitting such revenue on behalf of its affiliates API and DonTech. Id.

While the Company complains that if API of Illinois had paid $126 million in revenues to AI rather than the $75 million it actually paid, its revenues would have been reduced substantially, Mr. Smith computed that API of Illinois would still earn a healthy return on equity in the 37.9 percent to 44.4 percent range. Id. at 35-36.[3] API witness Michael Barry, who testified in this docket on behalf of AI, stated that API would never agree to make payments to IBT at the levels Staff and Mr. Smith recommend. AI Ex. 11.0 at 7. However, as Mr. Smith noted, whether the affiliate API would or would not agree to make such payments to IBT is not really the issue. Indeed, Mr. Smith discovered that it does not appear that API has actually been paying to IBT the $126 million annual Directory Revenue amount used by the Commission in the prior case, Docket No. 92-0488. Instead, API has been paying IBT approximately $75 million annually, GCI/City states. The actual level of payments from API to IBT that API has been making or would "agree" to make is not determinative of the amount of Directory Revenue that should count against IBT's intrastate revenue requirement. GCI/City Ex. 6.2 at 36. GCI/City point out that it is up to the Commission, and not API, to determine "the appropriate amount of revenues from Yellow pages advertising that will count against IBT's revenue requirements." Price Cap Order at 101.

GCI/City witness William Dunkel also presented testimony supporting imputation of directory revenues from a policy perspective. Mr. Dunkel noted that the high revenues generated by the LEC-"endorsed" directory, i.e., the directory that bears the Ameritech name, are a by-product of the provision of basic local exchange service. He pointed out that directories that bear the LEC's name are valued more by both advertisers and customers. GCI/City Ex. 7.0 at 2-6. He noted that other LECs that do not possess an affiliated publishing arm typically collect a publishing fee from the non-affiliated publisher to the right to publish a directory with the LEC's name on it. Id. at 7. Ameritech's own advertising documents show that businesses place far more ads in the Ameritech Yellow Pages than in a publishing competitor's Yellow Pages published in the same area. GCI/City Ex. 7.1, p. 3. As shown on GCI/City Ex. 7.1, the API-produced directories have the Ameritech name on them. AI's failure to secure an agreement with API for compensation for this valuable endorsement cost the regulated company millions of dollars in revenue.

---

[3] Mr. Smith's Schedule E-1.1 details this calculation.

In response to Mr. Dunkel's position, AI witness Barry argues that the Ameritech name, and not Ameritech Illinois, appears on the API-published directories, and thus no AI brand equity has been established. AI Ex. 11.0 at 10.

GCI/City argue that this suggestion is not persuasive. As noted by Mr. Smith, the Ameritech name in included on the directories, and is also included in all Ameritech Illinois advertising, including both product and corporate image building advertising. Thus, even though the cost of non-product, corporate image-building advertising has and should be excluded from IBT's operating expenses for determining customer rates, Ameritech Illinois' customers have nevertheless been paying for product advertising expenses which include and reinforce the Ameritech name and "brand." The use of the Ameritech name (and now the SBC name as well) in Ameritech Illinois product advertising that is paid for by customers reinforces and promotes the recognition of that name. GCI/City Ex. 6.2 at 37-38. The API-published Ameritech directory is the only one that features a page dedicated to listing Ameritech Illinois' customer calling and repair centers. It is reasonable to assert that when customers see the Ameritech Yellow Pages they recognize the Ameritech name and associate this with the telephone company. Id.

AI witness Gebhardt argues further that because the contract expired at the end of 1999, the only relevant decision for the Commission is whether the contract payments Ameritech Illinois is receiving under its *new* agreements with API (for billing and collection and listing functions) are consistent with what Ameritech Illinois would have been able to achieve if it were negotiating with API at arm's length as if it were a non-affiliated publisher. AI Ex. 1.3 at 110 (emphasis added). Because the levels charged by AI for these functions are at the maximum rate permitted by the TA rule discussed above, Mr. Gebhardt opines that the answer to that question is yes. Id.

GCI/City argue that Mr. Gebhardt is mixing apples with oranges. The rates AI charges to API for billing and listing functions are not at issue here. The current relationship with Ameritech Illinois and its affiliates API and DonTech – a relationship that permits API to publish directories with the Ameritech name on them and receive all of the benefits associated with that endorsement while trying to divert virtually all Directory Revenues out of AI and into API so such revenues would no longer count in determining AI's intrastate revenue requirement or earnings level -- is the result of an affiliated interest transaction that this Commission found to be improper. Again, the rates charged by AI to API for listing and billing and collection services are not at issue.

As noted by Mr. Smith, no statute or regulation exists that prohibits Ameritech Illinois from publishing a Yellow Pages directory in Illinois, or attempting to charge advertisers rates similar to what API and DonTech currently charge them. The fact is AI and its corporate parent have chosen to forego these Directory Revenues and divert them to the unregulated affiliate, API.

Mr. Smith's Schedule E-1 Revised consists of four pages. Page 1 presents a summary of the Directory Revenue amount for use in the determination of IBT's intrastate revenue requirement. It summarizes the quantifications made by Mr. Smith, using different calculation methods. Page 2 shows the Directory Revenue amount for IBT of $163 million using growth in access lines to increase the amount from the Commission's prior decision. This calculation was also presented and discussed with Mr. Smith's direct testimony at pages 26-27. Page 3 shows the calculation of the Directory Revenue amounts for IBT of $141.5 million and $171.2 million, resulting from IBT retaining 36.2% of Directory Revenues, similar to calculations presented by Staff in the prior case. Page 4 shows the annual Directory Revenue from Illinois operations for IBT using pre-tax income information from the affiliate APII's income statements for 1999 and October 2000 year-to-date of $151.4 million and $136.8 million, respectively. As noted above, and shown on Schedule E-1 Revised, page 1, Mr. Smith used a level of $126 million annually for this adjustment, which is the amount approved by the Commission in the prior case, Docket 92-0448. As shown on GCI/City Ex. 6.5, Schedule E-1.1, imputing a Directory Revenue amount of up to $144 million, even assuming that the affiliate API paid such an amount annually to AI, would still leave API with a return on equity within the range that Staff is recommending for AI in this proceeding.

These quantifications, GCI/City assert, demonstrate the conservative nature of Mr. Smith's recommendation that the Commission impute at least $126 million in directory revenues to AI's 1999 operating income. GCI/City urge the Commission to adopt Mr. Smith's well-reasoned adjustment.

Commission Analysis and Conclusion

Determining the amount of revenue from directory advertising which should count toward IBT's intrastate revenue requirement is a critical issue in determining the Company's revenue requirement. Under Section 7-102(2) of the Act, the Commission has jurisdiction over affiliated interests having transactions with public utilities under the Commission's jurisdiction. API is an affiliate of AI.

In determining AI's intrastate revenue requirement, Yellow Page profits have been reflected as a contribution toward, or offset to, the cost of local telephone service. This has been the case in order to recognize the diversion of directory revenues away from the local, regulated telephone company and into an affiliate publishing company. The imputation of directory revenues recognizes, in effect, the payment of a royalty fee by the affiliated publisher of the directories – in this case, Ameritech Publishing Inc. ("API") -- to the local telephone company in recognition of the fact that but for the decision of the corporate parent Ameritech to funnel the directory publishing business into an affiliated company, the regulated local telephone company would be realizing the considerable revenues associated with this lucrative business.

In the 1994 Price Cap proceeding, the Commission reflected $126 million annually for directory revenue in deriving IBT's intrastate revenue requirement. The $126 million is comprised of the $75 million annually that IBT was receiving from an affiliate, Ameritech Publishing Inc. (API), plus an additional imputation of $51 million, based on a Staff adjustment that the Commission found to be reasonable. The Commission took into consideration the sizeable growth in the revenues from publishing Yellow Pages in Illinois, and concluded that because Illinois Bell did not participate in contract negotiations that affected the amount of revenue it would receive from the affiliate, it missed an opportunity to increase its revenues. Price Cap Order at 97. The Commission specifically concluded that "(b)y diverting the contract revenues from IBT to API, Ameritech shareholders received a windfall by not having the revenues count towards IBT's revenue requirements." Price Cap Order at 101.

This decision was upheld by the Illinois Appellate Court, which noted that the issue of imputing directory revenues implicates two sections of the Act: Section 7-102, which specifies a variety of intercorporate transactions requiring either Commission approval or waiver of approval; and Section 7-102(c), which bars a public utility from disposing of or encumbering any asset. The Court noted that "(a)n asset disposed of or encumbered for less than it is actually worth will increase a utility's revenue requirement and, in turn, its rates." Illinois Bell Telephone Company v. Ill. Commerce Commission, slip op. of July 17, 1996, attached as GCI/Ex. 6.4.

In addition, the Court cited Section 7-203 of the Act, which prohibits the transfer of any "franchise, license, permit or right to own, operate, manage or control" of any utility property without Commission approval, and construed it to prohibit unauthorized, incremental, as well as complete transferal of management authority. Id. The Court concluded that "to hold otherwise would permit utilities to do piecemeal that which they cannot do in toto: transfer control of a public utility to an unregulated entity. Id. Finally, the Court held that unless the Staff-proposed directory revenue imputation adjustment was upheld, "ratepayer would be forced to bear the burden of an increased revenue requirement caused by Bell's foregoing an opportunity to increase directory revenues …" Id.

Just as was the case in the 1994 docket, a similar issue of diversion of directory revenue is occurring in the current proceeding. Ameritech Illinois admits that an affiliate, API, is publishing Yellow Pages Directories in Illinois and obtaining revenue from such activities. In its 1999 operating income statement filed in this docket, Ameritech Illinois has again attempted to divert all such revenue to API, so that none of it is reflected in assessing the intrastate revenue requirement for AI, the regulated monopoly telephone company. Determining the amount of revenue from directory advertising which should count toward IBT's intrastate revenue requirement therefore is a critical issue in determining the Company's revenue requirement.

A few things have changed since the original Price Cap proceeding, and some have remained the same. The directory contract between IBT and its affiliates, API and DonTech[4], (i.e., the contract addressed in Docket No. 92-0488/93-0239) expired on December 31, 1999 and has not been renewed. In 1996, Congress passed the Telecommunications Act of 1996 ("TA 96"), which includes a provision (Section 222(e)) that requires IBT to provide non-affiliated directory publishers with listing information in a fair, impartial and nondiscriminatory manner, and limits IBT to charging such publishers $0.04 per directory listing and $0.06 per listing for updates. This provision of TA 96 does *not* prohibit telephone companies from publishing directories or selling advertising in such directories. Nor does it prohibit state regulatory commissions from using directory revenues in determining the intrastate revenue requirement for the telephone company. Entities within the Ameritech (now SBC/Ameritech) corporate group have continued to publish and distribute directories in Illinois and to realize substantial revenues from directory operations. Finally, it appears that the revenues being realized from the publication of such directories have increased substantially. GCI/City Ex. 6.0 at 22-23.

The issues concerning directory revenue in this case are: how much is the Ameritech corporate group receiving for the publishing and selling advertising in Illinois directories, and how much of such revenues and directory profits should be allocated to AI, the regulated telephone company, and reflected in AI's revenue requirement determination?

In the instant case, Ameritech is not arguing that IBT could not be the entity publishing the directories and reaping the Yellow Pages advertising revenue. Rather, GCI/City assert, in its current attempt to divert directory revenues away from AI and not have such revenues count against IBT's revenue requirement, Ameritech corporate management apparently made a decision to have a nonregulated affiliate, API, rather than Ameritech Illinois, the regulated telephone company, publish the directories. Just as the Commission concluded in the 1994 Price Cap Order, the issue before the Commission is to determine the appropriate amount of revenues from Yellow Pages advertising that will count against IBT's revenue requirements.

---

[4] The publishing relationship among the various Ameritech affiliates and the Reuben H. Donnelly Corporation can be described as follows: Donnelley has been publishing the Yellow Pages telephone directories for more than 100 years. Ameritech is the unregulated holding company holding all of AI's stock. API is a wholly-owned subsidiary of Ameritech created to compete with Donnelley by publishing a separate Yellow Pages directory. Both Am-Don and DonTech are separate partnerships API and Donnelley entered into for the purpose of publishing a combined Yellow and white pages directory. <u>See</u> GCI/City Ex. 6.4, at 1.

IBT's argument that the decision that API would publish the directories was made in a 1984 agreement that was approved by the Commission does not alter the need to impute directory revenues. The decision to permit its affiliate, API, to publish the directories was not the basis for the Commission's 1994 imputation of directory revenues, nor is it the basis for the imputation proposal in this docket. In 1994, what was relevant was that Ameritech Illinois failed to engage in arms-length negotiations with API, a related affiliate. If it had, the Commission concluded, it could have secured more favorable terms, i.e. additional revenues, from API. In this docket, the need to impute at least $126 million in revenues remains. The fact that API "had no desire to negotiate a comparable agreement for the future" is not a basis for assuming that Ameritech or Ameritech Illinois suddenly lost all bargaining power, given API's related affiliate status. Once, again, because API is a related affiliate, Ameritech and IBT permitted the contract to expire without renegotiation of the terms that prior to the contract's expiration, flowed through to IBT an additional $76 million in imputed revenues. Accordingly, neither the fact that the Commission once approved the contract between API, Donnelley, IBT and Ameritech nor the expiration of that contract changes the fact that revenues need to be imputed to the regulated monopoly, who but for the Ameritech Corporation's and IBT's decisions to (1) let API publish the directories, (2) fail to engage in arms-length negotiations to obtain better terms for the regulated monopoly, IBT, when extending the term of the contract to 1999, and (3) permit the contract to expire in December of 1999, IBT would have received, at a minimum, an additional $126 million in revenues from API.

Accordingly, we adopt the GCI/City/Staff-proposed directory revenues adjustment, which imputes $126 million to AI's test year revenues.

2. Depreciation Expense

AI's Position

It is Ameritech's position that because the Alternative Regulation Order granted Ameritech flexibility in establishing depreciation policy, a review of Ameritech's depreciation expense is beyond the purview of the Commission. Ameritech argues that a reduction in its depreciation expense as part of a reinitialization of rates would deprive it of the depreciation freedom granted by the Alternative Regulation Order and thus is not be permitted Although Ameritech admits that there was an error in its depreciation expense calculation, it does not believe that the depreciation expense error should result in any rate decrease.

With the exception of the depreciation expense calculation error, Ameritech asserts that its depreciation expense is based on sound accounting principles and on actual expenses incurred by Ameritech. For 1999 test year purposes, Ameritech asserts that its revised depreciation expense, after adjustment for errors corrected, is $607.9 million. This is $160.4 million less than Ameritech's original expense calculation of $768.2 million.

Finally, Ameritech contends that for 1999 test year purposes, it should be allowed to reduce its depreciation reserve by $362 million due to errors it committed in calculating its depreciation expense for the years 1995-1998.

City and GCI's Position

The City and GCI/Citydo not challenge the flexibility given to Ameritech to establish its depreciation practices during the time frame of the alternative regulation plan. However, the City and GCI/Citycontend that, for 1999 test year purposes, Ameritech's depreciation expense level must be reduced because it is improperly calculated and is not reasonable and representative on a going forward basis. The City and GCI assert that the proper depreciation expense for Ameritech is $382.4 million for 1999 test year purposes.

1. Credibility of expert testimony on depreciation

In this proceeding, the City and GCI provided more than 200 pages of testimony with numerous supporting exhibits of William Dunkel, a recognized depreciation expert regularly retained by state regulatory commissions across the country. GCI and City, Exhibit 8.0P, pp.1-3. The City and GCI argue that the depreciation testimony provided by Ameritech was inadequate and unreliable and that it should not be relied on by the Commission. Ameritech's testimony was presented by Ameritech witness Gebhardt, whose statement of qualifications does not establish any expertise, experience or training in depreciation (AI Ex. 1.0, pp.1-3). That testimony from a lay witness was supplemented by testimony from Ameritech witness Palmer, who also admitted that he was not an expert on depreciation. Tr. 1355 Consequently, the City and GCI argue that any opinions on depreciation from these Ameritech lay witnesses are of dubious admissibility and entitled to little or no weight.

2. Ameritech's depreciation errors.

The City and GCI remind the Commission of Ameritech's admitted error in its depreciation expense calculation. City and GCI witness Dunkel's analysis revealed that Ameritech had continued to record depreciation expense on accounts which had already been fully depreciated. The City and GCI further note that Ameritech only admitted to the $160.4 million error after it was detected by the City and GCI.

3. The reserve deficiency.

The City and GCI challenge Ameritech's inclusion of additional expense amounts reflecting what Ameritech alleges to be the amortization of a reserve deficiency. The City and GCI claim that elimination of these inappropriate amortizations ($151.6 million) would reduce Ameritech's depreciation expense amount from $607.8 million to $456.2 million for 1999 test year purposes.

(a). No Reserve Deficiency In 1999

The City and GCI assert that by the start of 1999, there was no reserve deficiency; there was a surplus. GCI and City Ex. 9.16. Accordingly, the City and GCI conclude that it would be inappropriate to include in test year expenses any amount reflecting an amortization of a reserve deficiency that did not exist.

Further, the City and GCI argue that the only evidence in the record on the reserve status at the beginning of 1999 for test year purposes was submitted by GCI and City witness Dunkel. It is shown on GCI and City Ex. 9.16. Mr. Dunkel's calculation of a reserve surplus on this exhibit, he testified, is a standard calculation that follows accepted depreciation practices.

(b). FAS 71 Amortization

The City and GCI state that the reported FAS 71 amortization expense of $108.4 million was inappropriate for the 1999 test year. The City and GCI posit that there is no annual amortization related to FAS 71 occurring on either Ameritech's financial reporting books or its books used for FCC purposes. Accordingly, any such amount should not be recognized for the sole purpose of intrastate ratemaking.

The City and GCI further assert that Ameritech did not request any "FAS 71" amortization treatment in the interstate jurisdiction. Even if Ameritech had requested this type of treatment and it had been granted, the City and GCI point out that the FCC has ordered that a FAS 71 amortization will be treated as a "below the line" expense, not to be considered an expense for rate making purposes. Thus, the City and GCI argue, there is no factual or regulatory basis for the disparate above the line treatment Ameritech requests.

4. Application Of Depreciation Rates

The City and GCI assert that an additional $105.7 million reduction in the depreciation expense level is appropriate. This assertion is based on GCI and City witness Dunkel's analysis. Mr. Dunkel used (a)1999, not 1995, information and (b) accepted plant life parameters, in determining the rates of depreciation he proposes. Ameritech's uses 1995 information.

(a). <u>1999 Data Is More Appropriate</u>

City and GCI witness Dunkel used the actual percent reserve calculated from Ameritech Illinois' books and Ameritech's actual investment distribution as of 1999 when applying his depreciation rates. GCI Ex. 9.0, P. 54-55. The City and GCI point out that most of the $105.7 million in depreciation expense attributable to the application of depreciation rates is related to the use of more current 1999 reserve accounts rather than1995 account information–not to the rates of depreciation. GCI Ex. 9.0, pp. 52-53.

(b). <u>More Reasonable Depreciation Parameters Should Be Used</u>

The City and GCI contend that Mr. Dunkel performed an independent analysis of the parameters that should be used by Ameritech. City and GCI witness Dunkel determined appropriate projection lives and other parameters for the 1999 forward looking pro forma test year.

Mr. Dunkel's analysis indicated that in the years 1995 through 1999, Ameritech Illinois had in fact kept its equipment in service for longer average lives than had been forecast when the depreciation parameters were selected back in 1995. GCI and City Ex. 8.0, p. 101. Longer projection lives means that depreciation expense should be lower, all other things being equal.

City and GCI witness Dunkel point out that for most of the major accounts, Ameritech plant projection lives for 1999 test year purposes would be longer than the projection lives the FCC is currently utilizing. Since the ICC has found the use of FCC parameters reasonable (ICC Docket 96-0486/96-0569, Second interim Order, February 18, 1998, p. 28), Mr. Dunkel is recommending that the ICC use those shorter FCC approved projection lives.

5. Depreciation Reserve .

The City and GCI assert that Ameritech should not be allowed to decrease its depreciation reserve by $362 million for 1999 test year purposes based on alleged non-test year accounting errors. The effect would be to allow Ameritech to double-recover depreciation expenses. City Br. at 55-57.

The City and GCI assert that these expenses were actually booked by Ameritech and that Ameritech already recovered these expenses from customers through rates that more than met its revenue requirement, with the $362 million included. The City and GCI assert that if Ameritech were allowed to reduce its depreciation reserve, Ameritech's test year net rate base and revenue requirement would increase accordingly. Ameritech would then use this higher revenue requirement to argue against any rate reduction that the Commission may enter in this case. Thus, Ameritech would collect this depreciation expense amount twice.

Staff's Position

Staff examined Ameritech's depreciation expense calculation and found it to be inaccurate. For 1999 test year purposes, Staff agrees with both the City and GCI that Ameritech's depreciation expense must be reduced by $160.4 million due to Ameritech's errors in accounting. Staff has further adopted the City and GCI's argument with regard to the FAS 71 adjustment. In addition, Staff asserts that an additional reduction of approximately $48 million in depreciation expense is appropriate. In summary, Staff calculates a proper depreciation expense of $450.8 million for 1999 test year purposes.

Commission Analysis and Conclusion

The Commission rejects Ameritech's assertion that the Alternative Regulation Plan stripped the Commission of the authority to examine the appropriate level of depreciation expenses on a going forward basis. Although the Alternative Regulation Plan allowed for flexibility in setting levels of depreciation, the Commission is empowered to make these adjustments. In the Alternative Regulation Order, the Commission advised Ameritech that it would continue to monitor Ameritech's depreciation policies and practices. The Commission restated its authority to re-evaluate the propriety of the Alternative Regulation Plan if any abuses were found. 1994 Order at p. 55

Because test year "booked data" has been shown not to be reasonable or representative for setting rates in the future, adjustments are appropriate. Under any regulatory regime, the Commission must assure that the rates produced are just and reasonable. It is imperative that the Commission use reasonable, representative depreciation expenses, particularly because depreciation expense is the largest single expense of the company. GCI and City Ex. 9.0, pp. 31-32. For the reasons stated below, the Commission finds that the proper depreciation expense for 1999 test year purposes is $382.4 million, as calculated by GCI and City witness Dunkel.

1. Credibility of expert testimony on depreciation

In evaluating the proper depreciation expense, the Commission recognizes the significant disparity in the expertise of witnesses on the depreciation issue and the support provided for their positions.. The City and GCI presented the testimony and supporting work of a depreciation expert. Mr. Dunkel, testifying on behalf of the City and GCI, is a recognized depreciation expert regularly retained by state regulatory commissions across the country. GCI and City, Exhibit 8.0P, pp.1-3. The Commission finds Mr. Dunkel to be an expert on depreciation and his testimony to be credible and persuasive.

In contrast, Ameritech's depreciation testimony was presented by lay witnesses – not depreciation experts. Despite having filed several exhibits on depreciation -- a subject matter requiring expertise and the exercise of judgment-- Ameritech witness Palmer admitted on cross examination that he was not a depreciation expert. Tr. 1355. And, Ameritech witness Gebhardt's statement of qualifications does not establish any expertise, experience or training in depreciation. Ameritech Illinois Ex. 1.0, P. 1-3. Consequently, the Commission finds that any opinions on depreciation matters from the Ameritech lay witnesses are entitled to little or no weight.

2. Ameritech's depreciation error.

All parties agree that Ameritech miscalculated its depreciation expense by at least $160.4 million. The primary cause of the miscalculation was Ameritech's continuing depreciation of accounts already fully depreciated. Therefore, the Commission finds that Ameritech's original depreciation expense must at the outset be reduced by $160.4 million.

3. No reserve deficiency.

Ameritech has incorrectly calculated amortization accounts based on a non-existent reserve deficiency. Relying on Mr. Dunkel's analysis, the Commission finds that by the start of 1999, there was no reserve deficiency; there was a surplus. GCI and City Ex. 9.16. The only evidence in the record on the reserve status at the beginning of 1999 for test year purposes was submitted by GCI and City witness Dunkel. It is shown on GCI and City Ex. 9.16. Mr. Dunkel's calculation of a reserve surplus on this exhibit is a standard calculation that follows accepted depreciation practices. The Commission accepts Mr. Dunkel's calculation. GCI Ex. 9.0, p. 50. Ameritech provided no evidence to demonstrate the existence of or to calculate the amount of any alleged reserve deficiency in 1999. Accordingly, test year expenses will not include any amount reflecting an amortization of a reserve deficiency that did not exist. Therefore, the Commission reduces Ameritech's depreciation expense by an additional $151.6 million.

The Commission does not rely only on Ameritech's failure to produce evidence to reach this conclusion. Ameritech proposed $108.4 million of annual expense as a "FAS 71" amortization. This is the largest alleged "reserve deficiency" amount that Ameritech included in its 1999 test year depreciation expense. However, there is no annual amortization related to FAS 71 on either Ameritech's financial reporting books or its books used for FCC purposes. Apparently, it exists only for purposes of this proceeding. There is no reason that any such amounts should be recognized uniquely for intrastate ratemaking purposes.

Moreover, even if the Commission were to find the existence of a reserve deficiency, which it does not, the Commission concludes that it should be treated as a "below the line" expense, not to be considered an expense for rate making purposes. The Commission's treatment of such an expense is consistent with the FCC's treatment of any FAS 71 amortization. Recognition accorded to any such expense will be considered a "below the line" expense for state regulatory purposes as well.

4. Application of Depreciation Rates.

The Commission finds that the applied depreciation rate amounts calculated by GCI and City witness Dunkel are more reasonable than Ameritech's rates because Mr. Dunkel used 1999, not 1995, information and accepted plant life parameters. Accordingly, the Commission finds that Ameritech's depreciation expense should be further reduced by an additional $105.7 million.

The Commission finds that Mr. Dunkel properly used the actual percent reserve calculated from Ameritech Illinois' books and Ameritech's actual investment distribution as of 1999. The Commission agrees with GCI and City witness Dunkel that in the years 1995 through 1999, Ameritech kept its equipment in service for longer average lives than had been forecast when the depreciation parameters were selected back in 1995. Longer projection lives means that depreciation expense should be lower, all other things being equal. The Commission also agrees that for most of the major accounts Ameritech's plant projection lives for 1999 test year purposes, as observed by Mr. Dunkel, would be longer than the projection lives the FCC is currently utilizing. Consequently, if the Commission adopted Mr. Dunkel's observed projection lives, Ameritech's depreciation level would be set at an even lower level than if the FCC's projection lives are used.

However, since the Commission has previously found the use of FCC projection life parameters to be reasonable (ICC Docket 96-0486/96-0569, Second interim Order, February 18, 1998, p. 28), the Commission agrees with Mr. Dunkel and adopts a more conservative approach in the instant case. The Commission will use the projection lives used by the FCC.

Finally, the Commission agrees with City and GCI witness Dunkel that $32.3M must be added back into the depreciation expense to avoid double counting of expense reductions in both depreciation rates and amortization. Accordingly, the Commission finds that for 1999 test year purposes, the appropriate level of depreciation expense is $382.4 million.

3. Pension Settlement Gains

a. Ameritech Illinois amounts

In 1999, the Company recorded $98.6 million in net pension settlement gains (a reduction to pension cost) as a result of applying Statement of Financial Accounting Standard Nos. 87 and 88 (FAS 87 and FAS88). GCI/City Ex. 6.2 at 25. Pension settlement gains refer to the decreased expense the Company achieves as a result of employees accepting retirement packages in a lump sums rather than drawing pension benefits over a period of years. Because these settlement gains (reductions to pension costs) were unusually high for the 1999 year, the Company proposed a pro forma adjustment that removes entirely the impact of the $98.6 million pension settlement gain as part of its adjustment to add $117.902 million to 1999 Corporate Operations Expense in Column B, Schedule 1 of AI Exhibit 7.0, Schedule 1. (Dominak).

GCI/City witness Ralph Smith testified that the $98.6 million should not be removed, as Ameritech Illinois has done, but rather should be amortized over a representative period, such as five years.[5] The adjustment to amortize this over five years would reduce Ameritech Illinois' proposed intrastate operating expense by $13.238 million. GCI/City Ex. 6.0 at 31, GCI/City 6.6, p. 3. This adjustment is reflected on GCI/City Ex. 6.5, Schedule E-3 Revised.

In response to this adjustment, AI witness Dominak claims that is not appropriate to consider the pension settlement gains as a current period gain. AI Ex. 7.2 at 32. GCI/City note in response, however, that Mr. Smith pointed out that the amount recorded in the 1999 test year for the pension settlement is a current period expense for 1999, and does not relate back to any prior period items. GCI/City Ex. 6.2 at 25. During cross-examination, Mr. Dominak confirmed that, in fact, these gains were attributable to people who elected to retire in 1999. Tr. 989-990. GCI/City argue that because it is a negative item (i.e., the result of a net gain) in this instance, it is a current period expense *credit*, or reduction to pension cost, in the current period that should be reflected in the test year, but amortized to reflect a normalized level of pension settlement gains. Mr. Smith's five-year amortization adjustment accomplishes that ratemaking goal.

The Company's response to data request BLV-041 shows that the Company recorded net pension settlement gains for 1999 in December 1999 of $98,633,840. GCI/City Ex. 6.2 at 27. That response also shows that the Company recorded net pension settlement gains for 2000 of $34 million in March 2000 and $50.639 million in June 2000 for IBT employees, and net pension settlement gains of $13,449,953 for the Illinois portion of ASI pension settlement gains for the first and second quarters of 2000. Id. Thus, for the first half of 2000 alone, GCI/City point out, IBT has recorded

---

[5] See, e.g., Commission Order in Docket Nos. 92-0448/93-0239, at page 109, where the Commission concluded that IBT's workforce resizing expenses should be amortized over a five-year period, which was the projected life of rates. The Commission also stated that this was consistent with its treatment of similar expenses in past orders.

approximately $98 million of additional pension gains. Id. Moreover, these gains recorded in 2000 relate to employees who retired in 1999. Thus the pension settlement gains IBT recorded in 1999 and 2000 relate to retirements in the 1999 test year, and should properly be included to some extent in the test year with a normalizing adjustment to address the unusually large amounts recorded in 1999 and 2000 relating to 1999 retirements. GCI/City asserts that wholesale removal of the amount, as the Company proposes, is not appropriate and does not reflect a normalized level of pension expense.

Mr. Dominak objected to Mr. Smith's selection of a five-year amortization period. AI Ex. 7.2 at 36. He claimed that if the gains are to be amortized, an 11.4 amortization period should be used for pension settlement gains related to retiring management employees and a 16-year period for gains related to retiring nonmanagement workers. Tr. at 1005.

GCI/City responded that Mr. Dominak's proposal should be rejected for a few reasons. First, these periods relate to the estimated remaining working lifetimes of employees who have *not* yet retired. Consequently, neither period is appropriate for an amortization of pension settlement gains for employees who *have* retired (i.e., are no longer employees and have a zero level remaining working expectation at AI.) Second, the retirements which generated the pension settlement gains recorded by IBT in 1999 were part of the work force changes experienced by Ameritech, and the cost reduction impacts of such known changes, should be recognized for ratemaking purposes. In Docket 92-0448/93-0239, the Commission determined that the Company's work force resizing expenses should be amortized over a five-year period, which was based on the projected life of rates. Price Cap Order at 109. In reflecting this amortization, the Commission stated that "such treatment is consistent with the Commission's treatment of similar expenses in past orders." Id. The Commission also concluded that management audit expenses should be amortized over a five-year period, the projected life of the rates, and stated that such treatment is consistent with the Commission's treatment of such expenses in past orders, GCI/City notes. Price Cap Order at 129.

Third, Staff witness Dianna Hathhorn, who also proposes a similar pension settlement gain adjustment, likewise selected a five-year amortization period. Staff Ex. 6.0, at 8. Third, Mr. Dominak confirmed during cross-examination that neither FAS 87 nor Generally Accepted Accounting Principles require that an amortization be based on a future working lifetime calculation. Tr. at 1008. Because the settlement gains relate to employees who already retired in 1999, their future working lifetime is zero. Accordingly, Mr. Dominak's criticisms of Mr. Smith's proposed amortization period should be rejected. A five-year amortization period is reasonable and appropriate under such circumstances, and is consistent with prior Commission treatment of similar cost impacts which are normalized for ratemaking purposes.

b. Pension Settlement Gains –Ameritech Services

In his rebuttal testimony, Mr. Dominak proposed several pro forma adjustments to the Company's 1999 income statement for "known and measureable changes which became known after that Exhibit (AI Ex. 7.0) was filed." AI Ex. 7.1 at 2. Among the changes to the test year proposed by the Company is an adjustment to again remove the impact of pension settlement gains – this time relating to amounts charged from Ameritech Services Inc. ("ASI") to AI in 1999. AI holds a one-third equity interest in ASI, which provides centralize services on behalf of the five Ameritech Operating Companies. AI's adjustment results in a decrease in the intrastate balance available for return of $11.18 million. Id.

GCI/City argue that similar to the treatment of the Ameritech Illinois pension settlement gains and curtailment losses, the Ameritech Services 1999 pension settlement gains should be amortized over a five-year period, rather than being excluded from the test year results entirely, as Mr. Dominak proposes in his rebuttal testimony. The five-year amortization is necessary for the same reasons the pension settlement gain amounts stemming from AI employee retirements should be amortized, and not ignored entirely as AI proposes. GCI/City Ex. 6.2 at 14. Consequently, rather than reflect the total removal of the Ameritech Services 1999 pension settlement gains and curtailment losses as Mr. Dominak proposes on IBT Exhibit 7.1, Schedule 1, Column D, GCI/City argues that the Commission should reflect a five-year amortization of such gains and losses, as shown on GCI/City Exhibit 6.3, Schedule E-15. This adjustment increases intrastate operating expense before taxes by approximately $14.829 million. It is $3.7 million less than the Company's adjustment to Corporate Operations Expense.

c. Pension Settlement Gains – Known 2000 Amounts

GCI/City witness Smith also made an adjustment to amortize over a five-year period the impact of $98 million in known pension settlement gains recorded by IBT in 2000 for retirements that occurred during the 1999 test year. These pension settlement gains were discussed by AI witness Dominak at pages 28-29 of his rebuttal testimony (AI Ex. 7.1) and were documented in information provided to the Commission Staff and Mr. Smith. GCI/City Ex. 6.2 at 22. During cross-examination, Mr. Dominak confirmed that these amounts, although recorded in 2000, related back to personnel who elected to retire in 1999, but did not receive the lump sum cash payout from the pension plan until 2000. Tr. at 996; AI Ex. 7.2 at 12. GCI/City argue that the five-year amortization period is consistent with Mr. Smith's other recommendations concerning the treatment of the similar 1999 pension settlement gains. This adjustment decreases intrastate expense by $13.169 million, and is reflected in Mr. Smith's Ex. 6.5, Schedule E-19.[6]

---

[6] An alternative calculation shown on Schedule E-19 shows what the impact of this adjustment would be if the

The Company objected to Mr. Smith's additional adjustment for the pension settlement gains recorded in 2000 in surrebuttal testimony. Mr. Dominak argued that Mr. Smith's adjustment to amortize over a five-year period the impact of known pension settlement gains recorded by IBT in 2000 amounts to a "double-counting". AI Ex. 7.2 at 17. GCI/City argued that Mr. Dominak is wrong. Mr. Dominak confirmed during cross-examination that when the Company recorded the approximately $98 million of pension settlement gains on its books in the first half of 2000, it did not double count the amount of pension settlement gains that it recorded in 1999. Tr. at 1030. This $98 million was a separate amount, distinct from the $98.6 million in pension settlement gains recorded by the Company in 1999. Id. However, the $98 million in pension settlement gains recorded in 2000 does *relate back to employees who actually retired in 1999 and received their lump sum payments in 1999*, GCI/City assert. Tr. 1031. The Company simply recorded in 2000 these additional amounts that relate to retirements that occurred during the 1999 test year. Accordingly, GCI/City argue that it is appropriate to amortize these additional 2000 amounts in order to reflect a normalized level of expense for the 1999 test year. Moreover, GCI/City point out that the Company's objection to amortizing gains recorded in 2000 is inconsistent with the Company's own pro forma proposed adjustments to its 1999 operating income statement for "known and measureable changes" associated with AI tariff changes made in 2000. AI Ex. 7.1, Schedule 1, Tr. at 1030.[7]

For all of the reasons stated above, GCI/City urge the Commission to adopt Mr. Smith's proposed pension settlement gain adjustments that are reflected in his Ex. 6.5, Schedules E-3 (AI Pension Settlement Gain), E-15 (Ameritech Services Pension Settlement Gain) and E-19 (AI Pension Settlement Gain – Known 2000 Amounts).

d. AI Response

In response to both Staff witness Hathhorn's and GCI/Citywitness Smith's proposed adjustment to normalize the 1999 test year level of pension settlement gains, IBT first argues that "settlement gains and losses recorded on the Ameritech Illinois' books in 1999 represent the recognition of gains and losses that occurred in prior periods." IBT Brief at 123. The Company adds that because the pension settlement

Commission adopts the Company's recommendation to revise the nonregulated factor applied to Corporate Operations expense from 13 percent to 4.63 percent. GCI/City Ex. 6.2 at 22.

[7] In that pro forma adjustment, shown on AI Ex. 7.1, Schedule 1, Column F, Mr. Dominak reflects and adjustment to increase intrastate revenue by $38.272 million and to increase Uncollectibles by $872,000 for the impact of additional 2000 tariff filings by the Company. Mr. Smith reflected the $38.272 million adjustment to increase revenue on GCI/CityEx. 6.3, Schedule E-16. Mr. Smith disagreed with the Company's computation of the Uncollectibles expense associated with the tariff changes, as discussed below in the section in this Brief on Uncollectibles.

gains recorded in 1999 were abnormally high due to the unusually large number of IBT employees who elected to receive their pensions in a lump sum payment, these amounts should be removed in their entirety from the 1999 operating income statement. Id. at 123-124.

While both GCI/Cityand Staff agree that the pension settlement gains recorded in 1999 were at an unusually high level due to the large number of retirements and lump sum dispersals, the Company's assertion that the amounts recorded on the books in 1999 represent the recognition of gains and losses that occurred in prior periods is inaccurate, according to GCI/City. As pointed out by Mr. Smith, the amount recorded in the 1999 test year for the pension settlement is a current period credit to expense for 1999, and does not relate back to any prior period items. GCI/City Ex. 6.2 at 25. During cross-examination, Mr. Dominak confirmed that, in fact, these gains were attributable to people who elected to retire in 1999. Tr. 989-990. Because it is a negative item (i.e., the result of a net gain) in this instance, GCI/City points out that it is a current period expense *credit*, or reduction to pension cost, in the current period that should be reflected in the test year, but amortized to reflect a normalized level of pension settlement gains. Staff witness Hathhorn testified that Company data showed that pension settlement gains recur on an annual basis. Staff Ex. 6.0 at 7. Both Staff witness Hathhorn and GCI/Citywitness Smith concurred that, for ratemaking purposes, the proper treatment of unusually large credits to expense, revenues or expense amounts is to amortize the amount to reflect the normal, recurring amount experienced by the Company on an annual basis – not the wholesale removal of the credit as the Company has done. GCI/CityEx. 6.2 at 25-26. GCI/City state that Mr. Smith's five-year amortization adjustment, reflected in Schedule E-3 and attached to CUB's Initial Brief, accomplishes that ratemaking goal.

The Company responded to Mr. Smith's proposed amortization of the ASI pension settlement gain amounts by alleging in its Brief that GCI/City's proposed adjustment of $16.938 million for both the IBT-specific and ASI-specific pension settlement gain amortization amounts exceeds the "normal" annual level of pension settlement gains experienced by IBT on an annual basis by $9.8 million. IBT Brief at 124. GCI/City respond that, in fact, the Company has taken the dollar value of the GCI/Cityadjustment ($16.9 million), which represents the amount by which the credit to pension expense is decreased, and alleged that that amount inappropriately exceeds the typical annual level of pension settlement gains. This apples-to-oranges comparison is inappropriate and meaningless. The fact remains that Mr. Smith's five-year amortization of the 1999 recorded level of pension settlement gains better reflects the normal, recurring amount experienced by the Company on an annual basis than IBT's wholesale removal of the expense credits.

The Company further opines that the use of a five-year amortization period is arbitrary. IBT Brief at 125. The Company argues that if the gains are to be amortized, an 11.4 amortization period should be used for pension settlement gains related to retiring management employees and a 16-year period for gains related to retiring nonmanagement workers. Tr. at 1005.

GCI/City state that IBT's characterization of the GCI/Staff-proposed amortization period and its own amortization proposal should be rejected for a few reasons. First, there is precedent for selecting five-year period. In Docket 92-0448/93-0239, the Commission determined that the Company's work force resizing expenses should be amortized over a five-year period, which was based on the projected life of rates. Price Cap Order at 109. The Commission also concluded that management audit expenses should be amortized over a five-year period, the projected life of the rates, and stated that such treatment is consistent with the Commission's treatment of such expenses in past orders. Price Cap Order at 129.

Second, the amortization periods proposed by IBT relate to the estimated remaining working lifetimes of employees who have *not* yet retired. Consequently, neither period is appropriate for an amortization of pension settlement gains for employees who *have* retired (i.e., are no longer employees and have a zero level remaining working expectation at AI.) Mr. Dominak confirmed during cross-examination that neither FAS 87 nor Generally Accepted Accounting Principles require that an amortization be based on a <u>future</u> working lifetime calculation. Tr. at 1008. Because the settlement gains relate to employees who already retired in 1999, their future working lifetime is zero.

Accordingly, GCI/City assert, IBT's criticisms of Mr. Smith's proposed amortization period should be rejected. A five-year amortization period is reasonable and appropriate under such circumstances, and is consistent with prior Commission treatment of similar cost impacts which are normalized for ratemaking purposes.

In its response to the GCI/City proposed amortization of IBT's 2000 pension settlement gain amounts, IBT argues that this adjustment "double-counts" this income statement item "by including adjustments for both the 1999 and 2000 pension settlement gains credits." IBT Brief at 125-126.

GCI/City respond that the record evidence shows the Company is wrong. During cross-examination, Mr. Dominak confirmed that these amounts, although recorded in 2000, related back to personnel who elected to retire in 1999, but did not receive the lump sum cash payout from the pension plan until 2000. Tr. at 996; AI Ex. 7.2 at 12. Mr. Dominak testified that when the Company recorded the approximately $98 million of pension settlement gains on its books in the first half of 2000, it did not double count the amount of pension settlement gains that it recorded in 1999. Tr. at 1030. This $98 million was a separate amount, distinct from the $98.6 million in pension settlement gains recorded by the Company in 1999. <u>Id.</u> However, the $98 million in pension settlement gains recorded in 2000 does *relate back to employees who actually retired in 1999 and received their lump sum payments in 1999*, GCI/City notes. Tr. 1031. The Company simply recorded in 2000 these additional amounts that relate to retirements that occurred during the 1999 test year. Accordingly, GCI/City contend that it is appropriate to amortize these additional 2000 amounts in order to reflect a normalized level of expense for the 1999 test year.

Moreover, GCI/City note that the Company's objection to amortizing gains recorded in 2000 is inconsistent with the Company's own pro forma proposed adjustments to its 1999 operating income statement for "known and measureable changes" associated with AI tariff changes made in 2000. AI Ex. 7.1, Schedule 1, Tr. at 1030. The five-year amortization period is consistent with Mr. Smith's other recommendations concerning the treatment of the similar 1999 pension settlement gains. This adjustment decreases intrastate expense by $13.169 million, and is reflected in Mr. Smith's Ex. 6.5, Schedule E-19.[8]

Commission Analysis and Conclusion

The Commission adopts all three of GCI/City witness Smith's proposed pension settlement gain adjustments that are reflected in his Ex. 6.5, Schedules E-3 (AI Pension Settlement Gain), E-15 (Ameritech Services Pension Settlement Gain) and E-19 (AI Pension Settlement Gain – Known 2000 Amounts). With respect to the AI pension settlement gains, the Commission concurs that the $98.6 million should not be removed, as Ameritech Illinois has done, but rather amortized over a representative period, such as five years.[9] The adjustment to amortize this over five years would reduce Ameritech Illinois' proposed intrastate operating expense by $13.238 million. The Commission is persuaded by the fact that the amount recorded in the 1999 test year for the pension settlement is a current period expense for 1999, and does not relate back to any prior period items. During cross-examination, Mr. Dominak confirmed that, in fact, these gains were attributable to people who elected to retire in 1999. Because it is a negative item (i.e., the result of a net gain) in this instance, it is a current period expense *credit*, or reduction to pension cost, in the current period that should be reflected in the test year, but amortized to reflect a normalized level of pension settlement gains. Mr. Smith's five-year amortization adjustment accomplishes that ratemaking goal.

The Commission likewise concurs that the pension settlement gains AI recorded in 2000 relate to employees who retired in 1999. Thus the pension settlement gains IBT recorded in 1999 and 2000 relate to retirements in the 1999 test year, and should properly be included to some extent in the test year with a normalizing adjustment to address the unusually large amounts recorded in 1999 and 2000 relating to 1999 retirements.

---

[8] An alternative calculation shown on Schedule E-19 shows what the impact of this adjustment would be if the Commission adopts the Company's recommendation to revise the nonregulated factor applied to Corporate Operations expense from 13 percent to 4.63 percent. GCI/City Ex. 6.2 at 22.

[9] See, e.g., Commission Order in Docket Nos. 92-0448/93-0239, at page 109, where the Commission concluded that IBT's workforce resizing expenses should be amortized over a five-year period, which was the projected life of rates. The Commission also stated that this was consistent with its treatment of similar expenses in past orders.

Wholesale removal of the amount, as the Company proposes, is not appropriate and does not reflect a normalized level of pension expense.

The Commission rejects AI's position that if the gains are to be amortized, an 11.4 amortization period should be used for pension settlement gains related to retiring management employees and a 16-year period for gains related to retiring nonmanagement workers. As noted in GCI/City's Briefs, these periods relate to the estimated remaining working lifetimes of employees who have *not* yet retired. Consequently, neither period is appropriate for an amortization of pension settlement gains for employees who *have* retired (i.e., are no longer employees and have a zero level remaining working expectation at AI.) Second, the retirements which generated the pension settlement gains recorded by IBT in 1999 were part of the work force changes experienced by Ameritech, and the cost reduction impacts of such known changes, should be recognized for ratemaking purposes. In Docket 92-0448/93-0239, the Commission determined that the Company's work force resizing expenses should be amortized over a five-year period, which was based on the projected life of rates. Price Cap Order at 109. In reflecting this amortization, the Commission stated that "such treatment is consistent with the Commission's treatment of similar expenses in past orders." <u>Id.</u> The Commission also concluded that management audit expenses should be amortized over a five-year period, the projected life of the rates, and stated that such treatment is consistent with the Commission's treatment of such expenses in past orders.

In addition, the five-year period is consistent with Staff's proposed five-year amortization period. Mr. Dominak also confirmed during cross-examination that neither FAS 87 nor Generally Accepted Accounting Principles require that an amortization be based on a <u>future</u> working lifetime calculation. Because the settlement gains relate to employees who already retired in 1999, their future working lifetime is zero.

Similar to the treatment of the Ameritech Illinois pension settlement gains and curtailment losses, the Ameritech Services 1999 pension settlement gains should likewise be amortized over a five-year period, rather than being excluded from the test year results entirely, as Mr. Dominak proposes in his rebuttal testimony. The five-year amortization is necessary for the same reasons the pension settlement gain amounts stemming from AI employee retirements should be amortized, and not ignored entirely as AI proposes.

4. Revenues Related to IBT's Failure to Meet Service Quality Standards

GCI/City argue that the foregone revenue associated with the Company's failure to meet service quality standards is similar to a cost incurred by IBT associated with the failure to meet acceptable service quality standards, and should not be charged to customers. GCI/City Ex. 6.0 at 37. By failing to include the full amount of service quality penalty amounts as revenues, the Company has done just that for ratemaking purposes. GCI/City argue that ratepayers should not be forced to pay extra when the Company fails to meet minimum acceptable service quality standards. Consequently, reflecting the level of pro forma revenue as if the Company had fully met service quality standards is necessary so that ratepayers do not subsidize or pay for poor quality service. Id. This adjustment, reflected in Schedule E-8 and attached to CUB's Initial Brief, restores $29.579 million of foregone revenue to the test year for the cumulative impact on the 1999 test year for IBT's failure to provide adequate service.[10]

The Company objects to this adjustment, arguing that it imputes revenues that IBT did not in fact receive during 1999. IBT Brief at 121. The Company further opines that customers have already received the benefit of cumulative reductions, and that if Mr. Smith's proposed adjustment is adopted, customers would receive the same rate reductions again, and an annual penalty of $29.579 million would be indefinitely locked into IBT's rates without regard to service quality. Id.

GCI/City respond that these arguments are red herrings and should be rejected. While it is correct that Mr. Smith's recommended adjustment imputes revenues to the 1999 test year that IBT did not receive because of its failure to meet Illinois service quality standards, such imputation is necessary in order that the 1999 test year revenues reflect, for ratemaking purposes, an appropriate level of revenues as if the Company had provided an adequate level of service to customers. GCI/City Ex. 6.2 at 44. By excluding these foregone revenues from the 1999 test year, the Company seeks to ensure that any going-forward revenue requirement established by the Commission would recoup these lost revenues. GCI/City point out that the foregone revenue associated with the Company's failure to meet service quality standards is a penalty that should not be charged to customers. The 1999 test year revenues that IBT has lost or foregone because of its failure to meet minimum service quality standards in the state must be added back, or imputed to IBT, in the determination of the 1999 test year revenue requirement, so they can be counted by the Commission in resetting IBT's intrastate rates in this proceeding. Id.

GCI/City note that failure to impute these foregone revenues lowers the Company's reported level of revenues, and causes the Company to report a lower earned return. The way to remove the impact of this penalty upon IBT's 1999 test year results is to restore, or impute, the revenues to the test year as if IBT had been providing at least a minimally acceptable level of service quality, and correspondingly did not incur the service quality penalties. This is what Mr. Smith's recommended adjustment accomplishes. Id. at 45.

The Company opines that if Mr. Smith's proposed adjustment is adopted by the Commission, it should be recalculated to impute only the annual amounts of revenue

[10] Pro forma Uncollectibles for the test year increase $494,000.

reductions required in the years 1996, 1997, 1998 and one-half of the 1999 year, for a total of $11.9 million. IBT Brief at 121. The Company asserts that reflecting the cumulative amount of reductions, as Mr. Smith does, overstates the amount of revenue lost during 1999.

GCI/City respond that the Company's proposal contradicts its assertion that the Commission should look at the cumulative effect of annual rate reductions when calculating how much rates have been reduced under price cap regulation. Ratepayers must not be penalized for ratemaking purposes for the Company's failure to achieve service quality benchmarks. Setting rates by imputing less than the total amount of revenues foregone lowers the Company's earned return, and accordingly increases its revenue requirement. Rates based on such an inflated revenue requirement would effectively reimburse the Company for the service quality penalty revenues foregone.

Commission Analysis and Conclusion

The Commission adopts Mr. Smith's well-reasoned adjustment, which increases revenue by $29.5 million, and increases Uncollectibles expense by $494,000. Such imputation is necessary in order that the 1999 test year revenues reflect, for ratemaking purposes, an appropriate level of revenues as if the Company had provided an adequate level of service to customers. By excluding these foregone revenues from the 1999 test year, the Company wrongly ensures that any going-forward revenue requirement established by the Commission would recoup these lost revenues. The Commission agrees that the foregone revenue associated with the Company's failure to meet service quality standards is a penalty that should not be charged to customers.

We also reject AI's proposal to impute only the annual amounts of revenue reductions required in the years 1996, 1997, 1998 and one-half of the 1999 year, for a total of $11.9 million. The Company's proposal contradicts its assertion that the Commission should look at the cumulative effect of annual rate reductions when calculating how much rates have been reduced under price cap regulation. Ratepayers must not be penalized for ratemaking purposes for the Company's failure to achieve service quality benchmarks. Setting rates by imputing less than the total amount of revenues foregone lowers the Company's earned return, and accordingly increases its revenue requirement. Rates based on such an inflated revenue requirement would effectively reimburse the Company for the service quality penalty revenues foregone.

5. Non-Product Corporate Image-Building Advertising

Both Staff witness Mary Everson and GCI/City witness Smith agreed that an adjustment to remove the expense associated with non-product, corporate-image advertising should be made.[11] Unlike product advertising, which is intended to sell specific products in order to increase regulated revenue, corporate-image advertising is of little or no benefit to Illinois jurisdictional ratepayers because its purpose is to promote the image of Ameritech, now SBC, these parties argue. GCI/City Ex. 6.0 at 35. While the Company may argue that it is appropriate to promote the corporate or Company image, the link between non-product advertising and increased sales of regulated services in Illinois is remote and not quantifiable, according to GCI/City. Therefore, it is appropriate to remove from the test year revenue requirement any non-product/image advertising expenses. GCI/City propose that the intrastate expense amount of $6.807 million identified in data request GCI/City 5.36 should be removed. Id.

In the Price Cap Order of Docket Nos. 92-0488/93-0239, the Commission disallowed such expense. Price Cap Order at 106-107. In that proceeding, both Staff and CUB/Cook witnesses proposed to disallow IBT's corporate image/goodwill advertising. At page 107 of its Order, the Commission stated that:

> The Commission agrees with Staff and CUB/Cook that the purpose of the advertising in question is to promote the Company's corporate image and goodwill. Accordingly, the Commission does not find this advertising to be a reasonable expense for the ratepayers to bear.

Id.

In opposition to this adjustment, the Company argues that non-product "brand" advertising benefits AI customers, without providing any specific examples of how this has occurred. AI Ex. 7.1 at 22. Conspicuously absent from the Company's discussion on this point is the identification of any particular service promoted or revenues collected as a result of these image-building ads.

The Company objects to Mr. Smith's proposed elimination from the 1999 test year of the $6.807 million of non-product, corporate-image advertising expenses. IBT Brief at 120. While admitting that these ads do not promote a specific product (and therefore help increase revenue), the Company argues that they are intended to "create positive images in the mind of consumers, thereby promoting sales of all of the Company's products and services. Id.

Commission Analysis and Conclusion

Consistent with the Commission's findings in Docket 92-0448, advertising to promote the Company's image and goodwill should be disallowed. Unlike product advertising, which is intended to sell specific products in order to increase regulated revenue, the link between non-product advertising and increased sales of regulated

[11] Ms. Everson also removed other "external relations" expenses related to review of pending legislation, public relations and investor relations activities. Staff Ex. 7.0 at 9. Her adjustment totaled $20.4 million. Id., Schedule 7.05.

services in Illinois is remote and not quantifiable. Its purpose is to promote the image of Ameritech, now SBC. Therefore, it is appropriate to remove from the test year revenue requirement any non-product/image advertising expenses. Precedent exists for disallowing this type of advertising. In the Price Cap Order of Docket Nos. 92-0488/93-0239, the Commission disallowed such expense. Price Cap Order at 106-107. Accordingly, we adopt the GCI/City proposed elimination from the 1999 test year of the $6.807 million of non-product, corporate-image advertising expenses.

6. Asset Disposition Accruals

The Company's 1999 Operating Income Statement included an adjustment to remove in its entirety a $5.518 million credit to expense associated with "asset disposition accruals." AI Ex. 7.0, Schedule 1. The effect of this adjustment was to increase the test year level of expense, thereby increasing the Company's revenue requirement. In discovery, the Company revealed that the $5.518 million related to the costs AI accrued over a number of years as the result of the sale of land and buildings that occurred in 1994, and that all transactions for land and buildings that were placed for sale in 1994 were completed. GCI/City Ex. 6.0 at 33.

GCI/City witness Smith noted that if the $5.518 million is to reverse expense over-accruals that built up over a period of several prior years, then a more appropriate ratemaking treatment would be to amortize the credit over a similar period, rather than remove it in its entirety as the Company's adjustment does. For the amortization period, Mr. Smith again used a five-year period, which is the approximate period associated with the build-up of this item. The adjustment reduces Ameritech Illinois' proposed intrastate operating expense by $.741 million, as shown in the table on page 34 of GCI/City Ex.6.0 and on Schedule E-5.

IBT responds that it was justified in removing this entire expense credit because the transaction that gave rise to the accruals "had nothing to do with 1999 operations." IBT Brief at 126. The Company avers that Mr. Smith's five-year amortization of this amount "improperly reflects prior period activities in the test year. Id. GCI/City reply that IBT's criticisms miss the mark for a couple of reasons. First, as explained by Mr. Smith, the basis for reflecting this credit in 1999 results is that the Company actually received the expense credit and recorded it in its 1999 results. GCI/City Ex. 6.0 at 34. IBT witness Dominak confirmed during cross-examination that the Company actually recorded the $5.5 million credit in 1999. Tr. 977. Moreover, CUB Dominak Cross Exhibit 9 confirms that IBT continued to make property sales during 1999 and 2000. Tr. 977-978. GCI/City assert that this fact supports including a representative amount of asset disposition accruals in the test year, rather than a wholesale removal of the amount as IBT proposes.

Commission Analysis and Conclusion

Mr. Smith's adjustment to amortize the credit for asset disposition accruals over the same time period the accruals occurred, rather than pluck the entire amount of the credit from the test year, as the Company has done, reflects a normalized level of the impact of this credit, and is hereby adopted. The basis for reflecting this credit in 1999 results is that the Company actually received the expense credit and recorded it in its 1999 results. IBT witness Dominak confirmed during cross-examination that the Company actually recorded the $5.5 million credit in 1999. Tr. 977. Moreover, CUB Dominak Cross Exhibit 9 confirms that IBT continued to make property sales during 1999 and 2000. Tr. 977-978. These facts support including a representative amount of asset disposition accruals in the test year, rather than a wholesale removal of the amount as IBT proposes.

7. Interest Synchronization

Both Staff witness Bill Voss and GCI/Citywitness Smith proposed interest synchronization adjustments that synchronize the rate base and cost of capital with the tax calculation. GCI/City Ex. 6.0 at 41; Staff Ex. 5.0 at 12. As noted by GCI/City, it is calculated by applying the weighted cost of debt to the recommended rate base to obtain a synchronized interest deduction for use in the calculation of test year income tax expense. CUB Initial Brief at 137.

The Company opposed an interest synchronization adjustment, arguing in its Brief that the adjustment does not allow for fluctuation in interest rates with the result of reflecting interest payments "the Company never made in 1999." IBT Brief at 127. GCI/City replied that the Commission should reject this criticism. Commission precedent for adopting an interest synchronization adjustment is long-standing, GCI/City note. The interest synchronization adjustment has been consistently used by the Commission in determining revenue requirements for the utilities it regulates. Moreover, the Commission specifically rejected IBT's argument in the Alt. Reg. Order. See Alt. Reg. Order at 103-104.

GCI/City note that GCI/City Ex. 6.5, Schedule E-11 Revised, attached to CUB's Initial Brief, shows the calculation of the interest synchronization adjustment based on the product of Mr. Smith's recommended intrastate rate base and the weighted cost of debt Mr. Smith shows for IBT on Schedule D. The amount of this adjustment will vary if a different weighted cost of debt or intrastate rate base is used. Id. at 42. The adjustment should ultimately be adjusted to correspond with the intrastate rate base and weighted cost of debt adopted by the Commission in this proceeding. Id.

Commission Analysis and Conclusion

The Commission hereby adopts the GCI/City-proposed interest synchronization adjustment, as shown in Mr. Smith's Schedule D. Commission precedent for adopting an interest synchronization adjustment is long-standing. The interest synchronization adjustment has been consistently used by the Commission in determining revenue requirements for the utilities it regulates. Moreover, the Commission specifically rejected IBT's argument in the Alt. Reg. Order. See Alt. Reg. Order at 103-104. The interest synchronization adjustment synchronizes the rate base and cost of capital with the tax calculation. GCI/City Ex. 6.5, Schedule E-11 presents the calculation of the interest synchronization adjustment. It applies the weighted cost of debt, which can be found on Schedule D, to the adjusted rate base amount from Schedule B in order to determine the interest deduction. The state and federal income tax rates are applied to the resulting interest deduction difference to determine the decrease in income tax expense. Id.

8. AI's Income Tax Expense Correction

At page 38 of his direct testimony (GCI/City Ex. 6.0), Mr. Smith discussed the need for making an adjustment to reduce income tax expense in the Company's test year Operating Income Statement on a total Company basis. In his rebuttal testimony, Mr. Dominak makes this correction to the income tax expense, as shown on AI Ex. 7.1, Schedule 3, which is incorporated in the "Prior Period Taxes & Nonregulated" amount in Mr. Dominak's Exhibit 7.1, Schedule 1, Column B. Mr. Smith reflected this correction to income tax expense on GCI/CityExhibit 6.5, Schedule E-14. It is hereby adopted by the Commission.

9. Merger Cost Exclusion

In his direct testimony, Mr. Smith discussed the need for an adjustment to the Company's 1999 Intrastate Operating Income statement to reflect the removal from expense of $13.874 million in merger costs. GCI/City Ex. 6.0 at 32. Per IBT's response to data request DLH-042, the previously reported amounts for merger costs recorded in 1999 were all recorded below-the-line by IBT. Id. Per IBT's response to data request DLH-027, the $13.784 million was not booked by or billed to IBT until 2000. Id. As explained by Mr. Smith, the $13.784 million is not a 1999 expense, is similar to other merger costs that IBT recorded below-the-line, and should be removed from expenses for the 1999 test year. Staff concurred and proposed an identical adjustment. The adjustment reduces Ameritech Illinois' proposed intrastate operating expense by $9.253 million.

In his rebuttal schedules and testimony, IBT witness Dominak reflected Mr. Smith's and Staff witness Hathhorn's adjustment for merger related costs. AI Ex. 7.1, Schedule 1, Column J. However, GCI/City witness Smith responded in his rebuttal testimony that the amount Mr. Dominak used is internally inconsistent with the remainder of his adjusted intrastate expense calculations shown on his Exhibit 7.1, Schedule 1. GCI/City Ex. 6.2 at 8. The calculation of the $9.253 million amount is shown on GCI/CityExhibit 6.5, Schedule E-4. Referring to line 2 of Schedule E-4, the nonregulated portion is calculated using 13%, based on the Company's calculation of the corresponding item on IBT Exhibit 7.0, Schedule 1, Column B, and details provided by IBT in response to data requests. The Company accepted this criticism and adopted a correcting adjustment. AI Ex. 7.2 at 31. The Commission hereby adopts these adjustments.

GCI/City point out that the merger costs are one of three components of the Company's proposed $117.902 million of so-called "prior period" expense additions in IBT Exhibit 7.0, Schedule 1, Column B, as detailed in IBT's response to data request DLH-005 and described on page 31 of GCI/City Ex. 6.0 (Smith Direct). On IBT Exhibit 7.1, Schedule 3, Mr. Dominak attempted to decrease the 13% nonregulated factor for the $117.902 million that he had previously applied on IBT Exhibit 7.0, Schedule 1, to 4.63%, thereby allocating more expense to regulated operations. CUB argues in its Brief that this change in the nonregulated factor is insupportable.

Commission Analysis and Conclusion

The Commission rejects IBT witness Dominak's proposed a revision to the non-regulated factor applied to the Company's proposed $117.902 million of so-called "prior period" expense, which resulted in a decrease in the 1999 intrastate balance available for return. AI Ex. 7.1 at 4. The $9.253 million amount reflected on IBT Exhibit 7.1, Schedule 1, Column J, is consistent with the Company's original filing (IBT Exhibit 7.0, Schedule 1) and with the GCI/Cityadjustment calculations, both of which used the 13% nonregulated factor for Corporate Operations Expense. However, the $9.253 million amount reflected on IBT Exhibit 7.1, Schedule 1, Column J, is internally inconsistent with the attempted revision of the nonregulated factor by Mr. Dominak on IBT Exhibit 7.1, Schedule 3. A consistent calculation of those amounts requires rejecting the expense increase associated with IBT's belated attempt to revise the nonregulated factor on its Exhibit 7.1, Schedule 3.

10. Software Cost Capitalization

In his direct testimony, Mr. Smith recommended an adjustment to correct the Company's failure to reflect in its 1999 test year filing the impact of an American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") No. 98-1, which addresses the capitalization of software costs. In general, this SOP requires that software costs be capitalized. Prior to the adoption of SOP 98-1 many companies, including AI, had been expensing internally developed software costs, which now must be capitalized in compliance with GAAP. Mr. Smith explained that, for ratemaking purposes, it was necessary to reflect the amortization into expense of software costs. The effect of the adjustment, as shown in GCI/City Ex. 6.5, Schedule E-10, decreases intrastate operating expense by $1.319.

In his rebuttal testimony, Mr. Dominak accepted this adjustment, but insisted that Mr. Smith used the wrong intrastate factor for purposes of calculating the adjustment. AI Ex. 7.1 at 9. Mr. Smith agreed that the "Plant Specific Operations" factor should be used, but noted that Mr. Dominak had not followed his own advice. GCI/City Ex. 6.2 at 12. Mr. Smith corrected that mistake, as shown in GCI/City Ex. 6.5, Schedule E-10, line 4. In his surrebuttal testimony, Mr. Dominak concurred with Mr. Smith AI Ex. 7.2 at 3) and made that correction.

Accordingly, the agreed-upon $1.3 million reduction to the 1999 intrastate expense level is hereby adopted.

11. Sports Team Sponsorship

AI responses to CUB data requests revealed that AI included $96,000 in intrastate expense associated with sports team sponsorship in the 1999 test year. GCI/City Ex. 6.0 at 36. Similar to the adjustment for non-product advertising, Mr. Smith proposed an adjustment to 1999 test year expense to remove the cost of sports team sponsorship. Id. Sports team sponsorship is not a cost of providing telephone service and represents costs incurred to promote goodwill toward the Ameritech name. Id.

In his rebuttal testimony, Mr. Dominak adopted this adjustment. AI Ex. 7.1 at 6-7. Mr. Smith's adjustment is reflected on Schedule E-7, and is hereby adopted by the Commission.

B. Rate Base Adjustments

1. Accumulated Reserve for Depreciation

The discussion of the depreciation reserve is included above with the rest of the depreciation issues.

2. Telephone Plant Under Construction

This category ratemaking category involves two issues: (1) was a normal level of Telephone Plant Under Construction (TPUC) included in the Company's test year rate base, and (2) how should the Interest During Construction ("IDC") associated with the TPUC be treated so that it is not double-counted? IBT reflected $79.525 million on a total Company basis and $59.034 million on an intrastate basis on AI Exhibit 7.0, Schedule 2. The Company's rate base amount is based on its December 31, 1999 balance. GCI/City witness Smith testified that it does not appear that AI reflected any amount for Interest During Construction ("IDC"), which is problematic given the need for consistency between the TPUC amount in rate base and the IDC amount in the income statement, as explained in GCI/City Ex. 6.0 at 44-47.

In addition, both Mr. Smith and Staff witness Hathhorn proposed an adjustment to reduce the intrastate TPUC amount because the amount IBT included in the test year exceeded the 12-month average TPUC balance significantly for all periods from November 30, 1996 through August 31, 2000, and is thus unrepresentative of normal conditions. GCI/City Ex. 6.0 at 49. Mr. Smith's adjustment reduces the TPUC amount by $13.130 million to reflect a normal level in this account based on a 36-month average, as shown in GCI/City Ex. 6.5, Schedule E-13. Staff witness Hathhorn first normalized the TPUC amount using a 13-month average, but on rebuttal adopted Mr. Smith's 36-month methodology. Staff Ex. 6.0 at 5; Staff Ex. 20.0 at 5.

In its Brief, IBT offers no argument against adopting Mr. Smith's adjustment. IBT Brief at 132. It merely notes that it in surrebuttal testimony, it added $26.8 million to Total Plant In Service ("TPIS") associated with a "plug-in circuit board equipment" accrual it alleges is now in service. Id.

In reply, GCI/City argues that the Company's attempt to add this amount to rate base as TPIS should be rejected because the record evidence shows the Company has not yet paid for the plant. As Mr. Dominak admitted during cross-examination, this $26.8 million amount actually was credited to an account payable or accrued liability, and has not yet been funded by shareholders. Tr. at 986-987. As of December 31, 1999, IBT was still using vendor financing (interest-free capital) to pay for this plant, as evidenced by the balance of $26.8 million listed in accounts payable. Tr. 988-989, 1177-1178. This fact is also revealed in AI Ex. 7.2, Schedule 4.

Finally, GCI/City point out that there is a need for consistency between the TPUC amount in rate base and the Interest During Construction ("IDC") amount in the income statement, as explained in GCI/City Ex. 6.0 at 44-47. Although Mr. Smith's IDC adjustment, which is consistent with updated FCC rules and the Uniform System of Accounts, is preferred, GCI/City accept Staff's representation in its Brief that the Commission has yet to adopt the updated rules. GCI/City submit that Staff's proposed treatment of the IDC amount is a reasonable method of achieving the desired consistency.

Commisson Analysis and Conclusion

The Commission adopts Mr. Smith's adjustment TPUC adjustment to rate base, which normalizes the test year level of TPUC, as detailed in GCI/City Ex. 6.5, Schedule E-13, E-13.1, and E-13.3. Adoption of this adjustment effectively deletes Mr. Dominak's proposed addition of the $26.8 million plug-in circuit board equipment to TPIS. The amount IBT included in the test year exceeded the 12-month average TPUC balance significantly for all periods from November 30, 1996 through August 31, 2000, and is thus unrepresentative of normal conditions. GCI/City Ex. 6.0 at 49. Consistent with this adjustment, the Commission also adopts Staff witness Hathhorn's proposed treatment of the IDC amount, which GCI/City agrees is a reasonable method of achieving the desired consistency.

3. Accumulated Deferred Income Taxes

AI subtracted $97.616 million for "Merger Issues" from the 1999 ADIT balance used as a rate base offset. GCI/City points out that responses to discovery and discussions with Company representatives revealed that the two major components of this item are (1) approximately $60 million relating to a "competitive declaration" and (2) approximately $21 million for a methodology change in the way AI estimated Uncollectibles. GCI/City Ex. 6.2 at 51.

Although the Company accepted the $18.685 million Uncollectibles expense adjustment proposed by GCI/Cityand Staff, IBT representatives indicated that approximately $19 to $20 million of this ADIT debit balance had been included in the $281.084 million intrastate ADIT balance shown on Company Exhibit 7.0, Schedule 2, Column E. GCI/City Ex. 6.2 at 19. Just as the impact of the Uncollectibles methodology change should be removed from the test year, GCI/City argue that the related ADIT debit balance item of approximately $19 to $20 million for Uncollectibles should also be removed from rate base, as shown on Schedule E-17, attached to CUB's Initial Brief. GCI/City Ex. 6.2 at 19.

The Company argues in its Brief that the $19 million ADIT adjustment proposed by Mr. Smith is incorrect because "only the tax effect of the $18.675 million adjustment to uncollectible expense would impact the rate base." IBT Brief at 133. The Company argues the correct adjustment to ADIT is $7.412 million. Id.

GCI/City responded that the Company again muddles the record. Mr. Smith performed a detailed analysis of the ADIT balances IBT included in the 1999 rate base through discovery and discussions with IBT personnel. GCI/City Ex. 6.2 at 18-19. As shown on GCI/City Ex. 6.5, Schedule E-17, line 4, despite the fact that IBT removed the $21 million associated with Uncollectibles expense in accordance with its adoption of this Staff-/GCI-proposed adjustment, about $19 million in the ADIT balance associated with the Uncollectibles expense remains in the rate base for the test year, and needs to be removed, notwithstanding IBT's assertions to the contrary, GCI/City argue. The adjustment indicated on Schedule E-17, attached to CUB's Initial Brief should be adopted.

Commission Analysis and Conclusion

The Commission concurs with GCI/City that about $19 million in the ADIT balance associated with the Uncollectibles expense remains in the rate base for the test year, and needs to be removed, notwithstanding IBT's assertions to the contrary. Although the Company accepted the $18.685 million Uncollectibles expense adjustment proposed by GCI/Cityand Staff, IBT representatives indicated that approximately $19 to $20 million of this ADIT debit balance had been included in the $281.084 million intrastate ADIT balance shown on Company Exhibit 7.0, Schedule 2, Column E. Just as the impact of the Uncollectibles methodology change should be removed from the test year, the related ADIT debit balance item of approximately $19 to $20 million for Uncollectibles should also be removed from rate base.

4. Materials and Supplies

Ameritech Illinois Exhibit 7.0, Schedule 2 (Dominak) reflects $1.680 million of intrastate Materials and Supplies (M&S). As reflected on Schedule E-12 in GCI/City Ex. 6.5, Mr. Smith adjusted the intrastate Materials and Supplies amount upward to reflect a more appropriate balance. The year-end amount used by Ameritech Illinois is lower than the monthly balances listed in response to data request SDR-017, on Schedule B-8.1. GCI/City Ex. 6.0 at 43. A significant decrease occurred in October 1999 after the Company reflected an accounting policy change. The Company's response to data request CUB 13.3(c) stated that IBT anticipates an M&S balance of between $3.5-to-$4 million over the next 12 to 18 months. Schedule E-12.1 analyzes the monthly balances of M&S after the Company accounting change. During this post-accounting change period, the monthly M&S balances ranged from $2.258 million to $4.645 million, and averaged $3.16 million. On Schedule E-12, Mr. Smith used $3.5 million to derive the rate base allowance for M&S, prior to non-regulated and intrastate allocations. The net result of the adjustment is an increase to intrastate rate base of $924,000 to reflect the current ongoing level of Materials and Supplies.

In his rebuttal testimony, Mr. Dominak agreed that Mr. Smith's 1.242 million adjustment to the amount of materials and supplies included in intrastate rate base is appropriate. AI Ex. 7.1 at 8. This amount is hereby incorporated in the Commission's revenue requirements calculation.

5. Rate Base Increase.

Ameritech seeks to reduce its depreciation reserve for the 1999 test year by $362 million. The $362 million represents a portion of the amount of depreciation expense <u>actually booked</u> and recovered from customers by Ameritech for the years 1995-1998. The Commission agrees that Ameritech should not be allowed to reduce its depreciation reserve for 1999 test year purposes. The Commission concludes that this would, in effect, allow Ameritech to double recover this depreciation expense.

The Commission notes that Ameritech's proposal to reduce its depreciation reserve is only for rate making purposes. Ameritech testified that it has no plans to restate its books for 1995-1998, and it is not planning to provide a refund to customers whose rates paid that depreciation expense in 1995-1998. Tr. 1664-1680. In effect, Ameritech asks the Commission simply to pretend that Ameritech booked less depreciation expense that it actually did, and that it collected less from customers than it actually did.

D. Cost of Capital

1. Capital Structure and Cost of Debt

a. AI's position

AI witnesses David Gebhardt and Roger Ibbotson testified that Ameritech's target market-weighted capital structure should be used to calculate the overall cost of capital for revenue requirement purposes in the event that the Commission orders rate re-initialization or a return to rate of return/rate base regulation in this proceeding. Both witnesses stated that Ameritech's target market-weighted capital structure is that of its publicly traded peer group, which consists of 75.09% equity and 24.91% debt. AI Ex. 1.1 at 111; AI Ex. 6.0, at 10, 38. Dr. Ibbotson estimated the target market capital structure by averaging the book value of debt for each company in his peer group over the three years of 1997, 1998, and 1999. AI Ex. 6.0 at 39, and Schedule 12.

Dr. Ibbotson estimated the cost of short-term debt to be 5.81%, based on the average of the yields of one-, two-, and three-month commercial paper on January 31, February 29, and March 31, 2000. AI Ex. 6.0 at 37-38. His 7.91% estimate of the cost of long-term debt was derived using the average yield on thirty-year AA long-term corporate bonds across the same three dates. AI Ex. 6.0,Schedules 11 and 13. He arrived at the 6.71% cost of total debt by multiplying his cost estimates by the respective balances of short-term and long-term debt. AI Ex. 6.0, Schedule 13.

AI witness William Avera argued in favor of a market value capital structure on Ameritech's behalf in rebuttal and surrebuttal testimony. AI Ex. 8.1 at 9-14; AI Ex. 8.2 at 4-5. In his rebuttal testimony, Dr. Avera agreed that under the traditional rate of return regulatory framework, book value capital structure is appropriate. Ameritech Ex. 8.1 at 9. Dr. Avera continued to argue that since Ameritech has entered the competitive world, the Commission should not look at certain services as if they remained under rate of return regulation. AI Ex. 8.2 at 4.

b. Staff's position

Staff witness Alan Pregozen recommended using Ameritech's book value capital structure for the year ended December 31, 1999 to determine the weighted average cost of capital in the event that the Commission re-initializes Ameritech's rates. Mr. Pregozen's recommended capital structure comprises 22.03% short-term debt, 18.00% long-term debt, and 59.94% common equity. Staff Ex. 11.0, Schedule 11.01. He testified that a book value capital structure is appropriate for determining Ameritech's weighted average cost of capital in the event that the Commission orders rate re-initialization for noncompetitive services on the basis of traditional rate of return regulation. Staff Ex. 11.0 at 6. Mr. Pregozen determined that his recommended capital structure for Ameritech was reasonable since the total debt ratio of 40.06% that he proposed is consistent with the Standard & Poor's benchmark of 42% debt and under for AA-rated telecommunications companies. Id. at 8.
Mr. Pregozen estimated that Ameritech's balance of short-term debt averaged $671,284,205 over the June 1999 through June 2000 period. Id. at 7. An average balance eliminates the substantial fluctuations to which short-term debt balances are subject during a year. The June 1999 through June 2000 period was chosen because it is centered in time at December 31, 1999, the measurement date for the other components of the capital structure. Mr. Pregozen testified that the appropriate cost of short-term debt was 6.61%. He based this estimate on the current annual yield on thirty-day "AA nonfinancial" commercial paper, since virtually all of Ameritech's short-term debt is in the form of commercial paper with an average maturity of about thirty days. Id. at 9.

Mr. Pregozen testified that the balance of long-term debt outstanding as of December 31, 1999 was $547,746,000 and its cost was 6.73%. Id. at 9-10, and Schedule 11.03. The balance of common equity that Mr. Pregozen recommended was $1,824,500,000, which the Company reported in its annual report to the Federal Communications Commission. Id. at 8.

GCI/City's Position

GCI/City witness Ralph C. Smith used Staff's recommended capital structure and cost of short-term debt and long-term debt to calculate Ameritech's revenue requirement on behalf of GCI/City. GCI/City Ex. 6.0 at 14.

2. Return on Common Equity

a. AI's position

AI witness Ibbotson performed a two-stage Discounted Cash Flow ("DCF") analysis and a risk premium (Capital Asset Pricing Model or "CAPM") analysis on a group of peer companies to estimate the cost of equity for Ameritech. He estimated that the cost of equity for Ameritech is within a range of 11.86% to 12.71%, based on the average cost of equity of its peer group. Ameritech Ex. 6.0 at 4. Dr. Ibbotson did not make an explicit adjustment for flotation costs in his cost of equity analysis. Id. at 37.

Dr. Ibbotson formed his peer group by examining publicly traded telecommunications companies in the Standard & Poor's Compustat database. He excluded long-distance companies, companies not included in Value Line's Telecommunications Services sector, companies with less than 50% of their sales in SIC code 4813, and companies with less than two years of available data. Id. at 12-13. He concluded that Ameritech was at least as risky as the proxy firms in the peer group due to Ameritech's high capital intensity and operating leverage, and an alleged loss of regulatory protection and accelerating competition. Id. at 14.

Dr. Ibbotson used the quarterly version of a two-stage DCF model to estimate the cost of equity for each peer group company. The first stage covers the next five years, and the second stage covers the long-term, defined as years six and thereafter. Id. at 19. He used analyst's recent estimates of five-year growth in earnings per share published by IBES and Value Line for his first stage growth rate. For the second stage growth rate, Dr. Ibbotson used the historical long-term real growth in the economy and then added an estimate of long-term inflation to arrive at a nominal growth forecast. Dr. Ibbotson measured the historical long-term growth in the economy by computing the compound annual growth in real (adjusted for inflation) Gross Domestic Product ("GDP") for the period 1948 to 1999. He then added his 3.3% real GDP historical growth estimate to his 4.1% inflation forecast, which was based on his assessment of the long-term inflation rate implied in bond yields. Id. at 21-22.

Dr. Ibbotson averaged the dividend yield for each peer group company as of February 29, March 31, and April 28, 2000 to estimate the dividend yield for his DCF analysis. The three companies in his peer group that did not pay dividends were excluded from his DCF analysis. Id. at 22-23.

In his CAPM analysis, Dr. Ibbotson averaged the yield on twenty-year U.S. Treasury bonds for the three dates of February 29, March 31, and April 28 to estimate the risk-free rate. Id. at 34. For the equity risk premium, he calculated the difference between the historical arithmetic mean return on the overall stock market, as measured by the total return on the Standard & Poor's 500 Index, and the historical average yield return on long-term U. S. Treasury bonds, measured over the period of 1926 to 1999. Id. To estimate beta, Dr. Ibbotson averaged the three-year IBES and two-year Bloomberg beta estimates for each company in the peer group. Dr. Ibbotson opined that the last five years might not accurately represent Ameritech's current risk given the rapid pace of change in the telecommunications industry and the dramatic events in recent years. Therefore, he thought that beta should be estimated over a shorter period. Id. at 34-35.

Dr. Ibbotson's estimate of the weighted average cost of capital for Ameritech ranges from 10.58% to 11.21%. He arrived at this estimate by applying Ameritech's target market capital structure to his estimates of Ameritech's cost of debt and his peer group cost of equity. Id. at 40.

Staff's Position

Staff witness Pregozen also measured the investor-required rate of return on common equity for Ameritech with the DCF and risk premium models. He performed the DCF analysis under constant-growth and two-stage non-constant growth scenarios. His risk premium analysis utilized the capital asset pricing model ("CAPM"). Since Ameritech's stock is not market-traded, he applied those models to a sample of five telecommunications companies comparable to Ameritech. Staff Ex. 11.0 at 10-31.

To form his telecommunications sample, Mr. Pregozen first researched Dr. Ibbotson's peer group companies. Next, Mr. Pregozen eliminated several of the companies in Dr. Ibbotson's peer group because of recent developments and lack of necessary data. This screening reduced the number of companies in the sample to four: Bell South Corporation, CenturyTel Inc., SBC Communications Inc., and Verizon Communications. To find additional companies comparable to Ameritech, Mr. Pregozen examined the revenue mix of telecommunications industry companies and eliminated those with less than fifty percent of revenue derived from local telephone operations, including access revenues. He also eliminated those companies that lacked the data necessary to conduct the DCF and CAPM analyses. One additional telecommunications company, Hickory Tech Corporation, met those criteria. Id. at 11; Tr. 2241-2243.

Under the constant growth DCF scenario, the firm's dividends (or earnings) are expected to grow at a constant rate. For his constant growth DCF scenario, Mr. Pregozen averaged the projected earnings growth rates provided by IBES and Zacks for each of the telecommunications companies in his sample. Staff Ex. 11.0 at 13-14. He measured the current stock price of each company in his sample using closing market prices from September 6, 2000. He testified that current stock prices are more appropriate than historical stock prices because the former reflect all information that is available and relevant to the market. Id. at 14-15. The expected growth rate was applied to the last four dividends paid to estimate the next four expected quarterly dividends. Id. at 15. Mr. Pregozen's DCF analysis under the constant growth scenario produced a 15.76% estimate of the required rate of return on common equity for the telecommunications sample. Id. at 16.

Under the non-constant growth DCF scenario, dividends are expected to grow at different rates during different future periods. For the non-constant growth scenario, Mr. Pregozen used the same growth rate estimates employed in the constant growth scenario for the short-term growth stage over the first five years. The second, or long-term growth stage, was assumed to continue into perpetuity. Since company-specific growth rates are unavailable, Mr. Pregozen used long-term economic growth for the second stage growth rate, which he measured by computing the compound forecasted annual growth in nominal Gross Domestic Product for the period from 2000 through 2019. Id. at 15-17. He used the same stock prices and dividends that were used in his constant growth scenario. Id. at 17. The DCF cost of equity equals 8.30% under the two-stage non-constant growth scenario. Id. at 18.

Mr. Pregozen used forecasted growth in nominal GDP as his second stage growth rate because it incorporates inflation expectations into the projected values that he used to estimate growth over the long-term. In contrast, Dr. Ibbotson used historical growth in real GDP plus his inflation forecast as his second stage growth rate. Mr. Pregozen testified that Dr. Ibbotson's inflation estimate is much higher than the forecasts of WEFA and the *Survey of Professional Forecasters*. When combined with his GDP estimate, it produces a nominal GDP forecast that is in excess of the yields on U.S. Treasury bond yields of all maturities. This does not make sense, according to Mr. Pregozen, since Treasury bond yields should incorporate both elements, GDP growth and inflation, plus a risk premium. Id. at 18.

The CAPM or risk premium model that Mr. Pregozen used to estimate Ameritech's cost of common equity is based on the theory that the market-required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. A risk premium represents the additional return investors expect in exchange for assuming the risk inherent in an investment. Id. at 19.

In his CAPM analysis, Mr. Pregozen computed an adjusted beta of 0.85, estimated over a sixty-month period. Id. at 20-23. He testified that a beta estimate using five years of monthly data is more appropriate than a shorter period. Mr. Pregozen stated that the rapid pace of technological change and the advent of competition in the telecommunications industry are not recent developments. The Commission altered the regulatory structure of Ameritech in Docket No. 92-0448 to allow the Company and the ratepayers to transition themselves to a more competitive telecommunications marketplace. Hence, use of five years of data to calculate beta is within the era of rapid structural and technological change in the telecommunications industry. In addition, a longer period incorporates more data points and is less susceptible to the wide variations as manifest in as comparison of the two-year and three-year beta estimates that Dr. Ibbotson employed. Moreover, use of monthly data mitigates the effect of non-simultaneous closing prices. Id. at 22-23.

To estimate the risk-free rate, Mr. Pregozen used the yield on thirty-year U.S. Treasury bonds because the WEFA and Survey of Professional Forecasters estimates of inflation and real GDP growth expectations indicated that the thirty-year U.S. Treasury bond currently more closely approximates the long-term risk-free rate. Id. at 27-28. He estimated the expected rate of return on the market by conducting a DCF analysis on the firms composing the Standard & Poor's 500 Index. Id. at 28. He then subtracted his estimate of the risk-free rate from this market return to determine the risk premium, multiplied the risk premium by his beta estimate, and added the result to his estimate of the risk-free rate. This resulted in a 14.62% estimate of the required rate of return on common equity for Mr. Pregozen's sample of telecommunications companies. Id. at 28.

Based on his DCF and CAPM analyses, Mr. Pregozen concluded that the investor required rate of return for Ameritech's common equity ranged from 11.80% to 14.40%, with a midpoint estimate of 13.10%. He formed this range by: 1) averaging the DCF-derived estimates of the required rate of return on common equity, or 12.03% and rounding to the nearest tenth of a percent, or 12.0%; 2) rounding the risk premium estimate of the required rate of return on common equity (14.62%) to the nearest tenth of a percent, or 14.6%; and 3) adjusting downward both ends of the range by 20 basis points to reflect the less risky position of Ameritech relative to the telecommunications sample as a whole. Id. at 29-30. Mr. Pregozen testified that no adjustment for issuance costs should be made to the investor-required rate of return on common equity for Ameritech. Id. at 30-31.

Hence, Staff's recommended overall cost of capital for Ameritech for revenue requirement purposes in the event that the Commission orders rate re-initialization in this proceeding ranges from 9.74% to 11.30%, with a midpoint estimate of 10.52%. Staff's recommended cost of equity ranges from 11.8% to 14.40%. Staff Ex. 11.0 at 31.

GCI/City's Position

GCI witness Smith utilized the low end of Staff's cost of equity range, 11.80%. GCI/City argue that selection of the lower, 11.8% figure is appropriate for several reasons.

First, in its 1994 Price Cap Order, the Commission determined the low end of Staff's proposed return on equity range was appropriate in recognition of the benefits the Company stood to gain under alternative regulation. Price Cap Order at 174. In doing so, the Commission determined:

In order to ensure a benefit to ratepayers from alternative regulation as required by the Act, the Commission adopts a return on equity of 11.36% based on the low end of Staff's CAPM and DCF calculations. Choosing the low end of the return on equity range is reasonable given the change in circumstances under alternative regulation. The Company will no longer face the constraints that it did under traditional rate of return regulation. For example, the Company will be allowed to set its own depreciation schedules (except for LRSIC studies, aggregate revenue tests and imputation studies) and will be allowed some price flexibility. Furthermore, the Company will benefit from the significant potential increase in earnings that it can obtain under alternative regulation. Hence, using the low end of a reasonable range of return on equity is appropriate. Alt Reg Order at 174. Of course, all of the advantages gained by AI in 1994 as a result of the adoption of price cap regulation remain today. Should the Commission adopt another alternative regulation plan, the Company will enjoy the same benefits that accompany the establishment of price cap regulation, namely the ability to set its own depreciation rates, increase its pricing flexibility and, most importantly, retain earnings in excess of its allowed rate of return.

Second, as discussed by GCI/City witness Smith in GCI/City Ex. 6.2 (Smith Rebuttal), the 11.8% ROE figure is reasonable in comparison to the cost rate for common equity for intrastate telephone operations in other recent cases in which Mr. Smith participated as a witness, as shown in this table:

Accordingly, GCI/City urges the Commission to adopt an 11.8% cost of equity, which represents Staff's low end of its recommended return on equity range for purposes of computing AI's revenue requirement for the reinitialization of AI's rates.

Commission Analysis and Conclusion

Having reviewed the evidence, Mr. Pregozen's estimate of Ameritech's capital structure, cost of debt and cost of common equity are the most appropriate for establishing Ameritech's allowed rate of return for purposes of rate reinitialization. To estimate Ameritech's cost of common equity, Mr. Pregozen used theoretically correct models that the Commission has accepted for years. In addition, Mr. Pregozen fully explained the reasons for his decisions including use of alternative growth rate scenarios in his DCF analysis, equally weighting the constant and non-constant growth scenario DCF estimates, and use of a five-year beta. We agree with Mr. Pregozen's criticism that Dr. Ibbotson's inflation estimate is much higher than the forecasts of WEFA and the *Survey of Professional Forecasters*. When combined with his GDP estimate, it produces a nominal GDP forecast that is in excess of the yields on U.S. Treasury bond yields of all maturities. This does not make sense, since Treasury bond yields should incorporate both elements, GDP growth and inflation, plus a risk premium.

Although Dr. Ibbotson estimated a lower cost of common equity using the same models as Mr. Pregozen, Dr. Ibbotson applied that cost to a market value-based capital structure that is unnecessarily and unreasonably expensive given the risks associated with noncompetitive telecommunications services.

In addition, we concur with GCI/City's position that selection of the lower, 11.8% figure is appropriate for several reasons. First, in our first Alt Reg Order, we determined the low end of Staff's proposed return on equity range was appropriate in recognition of the benefits the Company stood to gain under alternative regulation. Price Cap Order at 174. In doing so, we determined:

In order to ensure a benefit to ratepayers from alternative regulation as required by the Act, the Commission adopts a return on equity of 11.36% based on the low end of Staff's CAPM and DCF calculations. Choosing the low end of the return on equity range is reasonable given the change in circumstances under alternative regulation. The Company will no longer face the constraints that it did under traditional rate of return regulation. For example, the Company will be allowed to set its own depreciation schedules (except for LRSIC studies, aggregate revenue tests and imputation studies) and will be allowed some price flexibility. Furthermore, the Company will benefit from the significant potential increase in earnings that it can obtain under alternative regulation. Hence, using the low end of a reasonable range of return on equity is appropriate. Alt Reg Order at 174. All of the advantages gained by AI in 1994 as a result of the adoption of price cap regulation remain today. Under the new alternative regulatory plan adopted in this Order, the Company will enjoy the same benefits that accompany the establishment of price cap regulation, namely the ability to set its own depreciation rates, increase its pricing flexibility and, most importantly, retain earnings in excess of its allowed rate of return.

In addition, the 11.8% figure is reasonable is reasonable in comparison to the cost rate for common equity for intrastate telephone operations in other recent cases in which Mr. Smith testified and referenced at page 52 of his Rebuttal testimony.

Accordingly, we adopt, for purposes of reinitializing rates in this proceeding, an 11.8% cost of equity, which represents Staff's low end of its recommended return on equity range.

X. Rate Design

AI's Position

It is Ameritech's position that rates should not be reinitialized in this proceeding. Accordingly, the company has not proposed a specific and comprehensive rate design proposal under a scenario whereby rates would be reduced. Ameritech has taken the position, however, that if the Commission orders a rate reduction, network access line rates should not be reduced. Ameritech's proposal to rebalance rates was consolidated with the review of Ameritech's performance under the alternative regulation plan. The rebalancing proposal is the only affirmative rate design recommendation made by Ameritech. A description of this proposal was made in another section of this Order and shall not be repeated here.

Staff's Position

If the Commission decides to reduce rates, the Staff recommends that "usage rates should be reduced first, then usage rates for calling plans, and finally vertical and other services." Staff Ex. 28.0 at p. 15 Staff has specifically found acceptable GCI and City's proposal to reduce vertical services and Band A usage rates, and to eliminate the charges for non-published and non-listed numbers. Staff Ex. 28.0 at pp. 15-17

GCI/City's Position

GCI/City witness Smith's analysis supports a reduction in Ameritech Illinois' rates by $956 million. GCI/City Ex. 6.2,p. 3 Based on this analysis, GCI/City witness Dunkel proposed significant rate reductions for a variety of Ameritech's services. GCI and City Ex. 8.0 P, p. 11.

GCI/City's rate design proposal is summarized as follows:

1. Reduce residential and business network access line (NAL) rates by $1.30 per line per month;

2. Reduce residential and business rates for local usage in Bands A and B:

3. Reduce residential installation and connection non-recurring charges;

4. Reduce residential and business vertical service rates; and,

5. Eliminate the charges for non-published and non-listed numbers.

Commission Analysis and Conclusion

Based on the Commission's earlier finding that rate reinitialization is proper to establish just and reasonable rates, it follows that the Commission must determine the rates to be adjusted and the level of each rate adjustment in order to effectuate that rate reinitialization. As stated earlier, once these rates go into effect, the rate moratorium will be extended to basic residential services as the Commission defined those services in the 1994 Order. Based on the record in this case, the Commission concludes that the only comprehensive rate design proposal is the one submitted by GCI and the City. While the Commission has considered the views of Ameritech and Staff, the Commission finds the rate design proposals of GCI and the City to be superior and hereby adopts them.

In adopting GCI and City's rate design proposal, the Commission specifically adopts the proposal with respect to Ameritech's competitive and noncompetitive services. The Commission agrees with GCI and the City that the just and reasonable standard applies to all services, noncompetitive and competitive alike. In doing so, the Commission places Ameritech on notice that the Commission shall watch very closely any efforts to increase rates for competitive services immediately after a finding that the rates ordered in this case are just and reasonable.

1. Network Access Lines

GCI and the City recommend that residential and business network access lines in each Access Area be reduced by $1.30. GCI and City Ex. 8.0 P, pp.13-14. As the Commission stated earlier, it has adopted the NAL cost calculations recommended by GCI and City witness Dunkel based on his corrections to Ameritech's cost study. Te Commission agrees with GCI and the City that even with a rate reduction of $1.30, 100% of the loop and port facility costs would be fully recovered. Accordingly, the Commission finds that a reduction of $1.30 is reasonable. In the appendix to this Order, the Commission has attached Exhibit A, the current and new residential and business NAL rates.

GCI and the City contend that the annual revenue impact of this reduction for the residential NAL in the exchanges currently classified as noncompetitive is $63.6 million, including those 19 exchanges that Ameritech has recently reclassified back as noncompetitive. GCI and City Ex. 8.0 P, p. 13. GCI and the City also contend that the annual rate impact for the reduction in the business NAL is $1.5 million for those lines classified as noncompetitive and $28.3 when competitive access lines are included. Id. at 14.

2. Residential Service Order Charges

GCI and the City recommend that the residential order charge for new service should be reduced from $33.05 to $20.00, and the line connection charge should be reduced from $20.50 to $5.00. GCI and City Ex. 8.0 P, p. 14 The Commission adopts these rate changes. This would result in a total decrease from the current rate of $53.55 to $25.00 for a new service order for one line. Id. at 15. Ameritech recommended these rate reductions in its rate rebalancing proposal. Id. at 14. All non-recurring costs are covered at these rate levels. Id. at 15 According to GCI and the City, the revenue impact of this rate reduction would be $21,304,495. Id. at 15.

3. Residential Local Usage

Ameritech's local usage services are divided into mileage Bands A and B, with further division within each Band of peak, shoulder-peak and off-peak periods. GCI and City Ex. 8.0 P, p. 21 The Band A rates apply to calls within 8 miles and are charged on an un-timed basis at 5 cents during the peak period. Id. Band B rates apply to calls between 8-15 miles and are charged at 5 cents for the initial minute and 1 cent for each additional minute. Id. In Band B, there are "shoulder peak" and "off-peak" discounts of 10% and 40%, respectively, for both the initial and additional minutes. Id.

GCI and the City essentially recommends that all residential usage rates be reduced. GCI and City Ex. 8.0 P, pp. 22-25 All usage rates are producing substantial contribution over LRSIC costs and the rates the City proposes will cover those costs. GCI and City Ex. 8.0 P .22. This fact does not appear to be in dispute. GCI and the City's proposal would also include local usage calling plans including Ameritech's SimpliFive and 5&5 Plans and callback plans. Id. at 24-25. In the attached appendix to this Order, Exhibit B is a complete list of all the usage rate changes the Commission is adopting for residential local usage services.

According to GCI and the City, the overall revenue impact of the local usage rate reductions for residential usage would be $270,955,667. GCI and City Ex. 8.0 P, p. 25

4. Business Local Usage

Ameritech's business local usage services are divided into Bands A and B with the same mileage parameters as residential usage services. GCI and City Ex. 8.0 P, p. 26 However, for business local usage, all calls are timed . Id. GCI and the City are essentially recommending reductions in all of the business local usage services. Id. The proposed rates would reduce the overall contribution provided from 688% to 118%. Id. The overall revenue impact of GCI and the City's proposal would be an annual reduction of $223 million. Id. In the appendix attached to this Order, Exhibit C is a complete list of all of the rate changes the Commission is adopting for business local usage services.

5. Residential Vertical Services

Major residential vertical services include Call Waiting, Caller I.D., Add Name to Caller I.D. and Automatic Call Back. GCI and City Ex. 8.0 P, p. 29 GCI and the City are proposing rate reductions for a number of Ameritech's residential vertical services. Id. In the appendix attached to this Order, Exhibit D is a complete list of the rate changes the Commission is adopting for residential vertical services. According to GCI and the City, under these rates vertical services are still producing an overall contribution of 1,819% over LRSIC. Id. The overall revenue impact of residential vertical service rate reductions is $166,330,853. Id.

6. Business Vertical Services

The major business vertical services are similar in function to those available for residential services. GCI and City Ex. 8.0 P, p. 30. In the appendix attached to this Order, Exhibit E is a complete list of the rate changes the Commission is adopting affecting business vertical services. According to GCI and the City, with the proposed rate changes, the services will continue to provide substantial contribution in excess of LRSIC. Id. The revenue impact of this proposal is $11,770,394. Id. at 31

7. Residential and Business Directory Listings

GCI and the City recommend eliminating the charge for business and residential privacy listing rates (i.e. non-published and non-listed services). GCI and City Ex8.0 p, p. 31 GCI and the City also propose reducing the rates for the business and residence additional listing rates, the residence enterprise listing rate and the business and residence Custom Number Service rates. Id. In the appendix attached to this Order, Exhibit F, is a complete list of the rate changes adopted by the Commission. The revenue impact of the rate reductions for privacy listings for residential services is $16,910,225. For business services, it is $5,927,234. Id. at 33-34.

In its appendix attached to this Order, the Commission has attached Exhibit G which shows the cumulative revenue impact of all of the rate changes it is adopting in this Order.

VIII. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having considered the entire record herein and being fully advised in the premises, is of the opinion and finds that:

(1) Illinois Bell Telephone Company d/b/a Ameritech Illinois ("Ameritech", "AI" or the "Company")is an Illinois corporation engaged in the business of providing telecommunications services to the public in the State of Illinois and, as such, is a telecommunications carrier within the meaning of Section 13-202 of the Illinois Public Utilities Act ("Act");

(1) the Commission has jurisdiction over the parties and the subject matter of this proceeding pursuant to the Illinois Public Utilities Act;

(1) the recitals of fact and conclusions of law reached in the prefatory portion of this Final Order are supported by the evidence in the record and the law and hereby adopted as findings of fact and law;

(1) Ameritech's petition for rate re-balancing in Docket 98-0335, is denied;

(1) the CUB/AG complaint in Docket 00-0764, is granted to the extent that rates are reduced by $956 million;

(1) the findings of fact and conclusions of law set forth in the prefatory portion of this Order are supported by the record and are hereby adopted as findings of facts and conclusions of law for purpose of this Order;

(1) the terms and conditions of the alternative regulation plan contained herein shall replace the alternative regulation plan adopted in Docket 92-0448/93-0239 and to the extent they modify or conflict with the original terms and conditions as set forth in the Alternative Regulation Plan approved in 1994, the terms and conditions of this Order shall be controlling.

(1) the materials submitted by the parties in this proceeding on a propriety basis and for which propriety treatment was requested are hereby considered propriety and shall continue to be accorded proprietary treatment;

(1) any petition, objections, and motions in this docket that have not been specifically disposed of should be disposed of in a manner consistent with our conclusions herein.

IT IS FURTHER ORDERED that the terms and conditions of the alternative regulation plan contained herein shall replace the alternative regulation plan adopted in Docket 92-0448/93-0239 and to the extent they modify or conflict with the original terms and conditions as set forth in the Alternative Regulation Plan approved in 1994, the terms and conditions of this Order shall be controlling;

IT IS FURTHER ORDERED that Ameritech's petition for rate re-balancing in Docket 98-0355,is denied.

IT IS FURTHER ORDERED that the CUB/AG complaint in 00-0764 is granted to the extent that Ameritech's rates are reduced by $956 million.

IT IS FURTHER ORDERED that any objections, motions or petitions not previously disposed of are hereby disposed of consistent with the findings of this Order.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.880, this Order is not final; it is not subject to the Administrative Review law.
June 13, 2001

Submitted as Exceptions by:
Government and Consumer Intervenors and the City of Chicago (GCI/City)
Brief on Exceptions filed separately.

THE CITY OF CHICAGO
Mara S. Georges
Corporation Counsel
Jack A. Pace
Assistant Corporation Counsel
Regulatory and Aviation Litigation Div.
30 N. LaSalle St., Suite 900
Chicago, Illinois 60602
(312) 744-6997

THE PEOPLE OF THE STATE OF ILLINOIS
James E. Ryan, Attorney General

Janice A. Dale, Susan L. Satter
Assistant Attorneys General
Public Utilities Bureau
100 Randolph St., 11h Floor
Chicago, Illinois 60601
(312) 814-1104

CITIZENS UTILITY BOARD

Karen L. Lusson
One of its attorneys
349 S. Kensington Avenue
LaGrange, Illinois 60525
(708) 579-9656

COOK COUNTY STATE'S ATTORNEY'S OFFICE, Richard A. Devine, State's Attorney
Marie Spicuzza, Allan Goldenberg
Assistant State's Attorneys
Cook County State's Attorney's Office
69 West Washington, St., Suite 700
Chicago, Illinois 60602
(312) 603-8624